



Debt and equity financing

Handbook

US GAAP

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Complex instruments, Complex literature

The array of accounting literature on financial instruments can be bewildering, and the varieties and complexities of modern financial instruments are sometimes staggering. Taken together, it's not an exaggeration to say that accounting for debt and equity financing transactions can seem daunting.

Determining the right accounting can require you to maneuver through multiple standards and models just to arrive at the starting point. This Handbook uses roadmaps to navigate the different standards, explaining what guidance applies to what types of instruments. It provides an in-depth look at the broad and often complex issues related to the classification, measurement, presentation and disclosure of financing instruments. And it includes examples demonstrating how to apply the standards to some common financing transactions.

We hope you find this Handbook useful in understanding how the guidance fits together and applies to financial instruments – from the simple to the most complex.

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About this publication

The purpose of this Handbook is to assist you in accounting for debt and equity financial instruments in the scope of:

- ASC 405, liabilities
- ASC 470, debt and convertible instruments
- ASC 480, distinguishing liabilities from equity
- ASC 505, equity instruments
- ASC 815, embedded features in debt and equity instruments and contracts in an entity's own equity.

Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we encounter in practice. We include examples to explain key concepts.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples:

- 470-10-25-1 is paragraph 25-1 of ASC Subtopic 470-10
- 2009 AICPA Conf is the 2009 AICPA National Conference on Current SEC Developments
- AAG-DEP 17.24 is paragraph 24 of chapter 17 of the AICPA's Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies
- AICPA TQA.4210.04 is section 4210.04 of the AICPA's Technical Questions and Answers
- ASU 2020-06.BC123 is paragraph 123 of the basis for conclusions to Accounting Standards Update 2020-06
- CAQ 06/2009 is meeting minutes from the June 2009 Center for Audit Quality SEC Regulations Committee
- FSP FAS 150-3 is FASB Staff Position 150-3
- S-X Rule 5-02.27(c) is Rule 5-02.27(c) of SEC Regulation S-X
- SEC statement (4/12/21) is the SEC Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies (SPACs)

November 2024 edition

This edition of the Handbook includes new and updated interpretations based on our experience with companies applying the accounting guidance for debt and equity financing instruments. Compared to the August 2023 edition, new Questions and Examples are identified with **, items that have been significantly updated or revised are identified with #, and moved items are identified with ^^ . The *Index of changes* identifies all significant changes.

Pending content

This edition of our Handbook incorporates amendments to Topic 480, 505 and 815 from ASU 2024-02, Codification Improvements—Amendments to Remove References to the Concepts Statements. However, the Codification excerpts containing the amendments from this ASU are reproduced as if the pending content were currently effective for all entities – i.e. the amendments are not labeled as pending content.

In contrast, the amendments in ASU 2023-06, Disclosure Improvements: Codification Amendments in Response to the SEC’s Disclosure Update and Simplification Initiative, are labeled as pending content in the Codification excerpts. Our interpretive guidance presumes these amendments have **not** been adopted.

In the Codification excerpts labeled as pending content:

- the specific sentences that have been superseded are struck out and the added text is underlined; and
- the amended sentences are marked as pending content.

Recent ASU

ASU 2023-06, Disclosure Improvements: Codification Amendments in Response to the SEC’s Disclosure Update and Simplification Initiative

In October 2023, the FASB issued ASU 2023-06, which incorporates into the Codification several disclosures and presentation requirements currently residing in SEC Regulations S-X and S-K.

As a result, the ASU is not expected to significantly affect entities currently subject to these SEC requirements. However, the effect of the ASU will be two-fold.

It will require certain disclosures currently in Regulation S-K that SEC registrants present outside the financial statements to be relocated to the financial statements and accompanying notes.

It will, as a result, require non-SEC registrants to make those disclosures as well.

The ASU’s amended disclosure and presentation requirements are to be applied on a prospective basis. For SEC-regulated entities and those required to file financial statements with the SEC for securities offerings, the effective date for amendments will be when the SEC removes the related disclosures from Regulation S-X or Regulation S-K, and early adoption is not permitted. For other entities, the amendments will be effective two years later and early adoption is permitted. If the SEC has not removed the existing disclosure requirement from Regulation S-X or S-K by June 30, 2027, the corresponding pending disclosure requirements will be removed from the Codification and will not become effective for any entity.

Abbreviations

We use the following abbreviations in this Handbook:

AOCI	Accumulated other comprehensive income
APIC	Additional paid-in-capital
ARS	Auction rate securities
ASR	Accelerated share repurchase
EBITDA	Earnings before interest, taxes, depreciation and amortization
EPS	Earnings per share
ESOP	Employee Stock Ownership Plan
IRR	Internal rate of return
ISDA	International Swaps and Derivatives Association
LIBOR	London Interbank Offered Rate
MD&A	Management's Discussion and Analysis
NCI	Noncontrolling interest
NFP	Not-for-profit entity
OCI	Other comprehensive income
SOFR	Secured Overnight Financing Rate
PIK	Paid-in-kind
TDR	Troubled debt restructuring
WHT	Withholding tax

1. Executive summary

This Handbook is a guide to accounting for debt, equity and equity-linked instruments. Whether these instruments are treated as equity or liabilities (or sometimes assets) depends on their terms and substance. For example, an equity instrument with debt-like terms is often treated as a liability in the financial statements.

Determining the appropriate accounting for these instruments often requires analyzing a number of Codification Topics, each with its own criteria and tests. It also can involve considerable judgment as to how future events can affect these instruments.

The contents of each chapter of this Handbook are summarized below.

Identifying relevant accounting guidance for debt and equity instruments

The Codification contains several Topics that may be relevant to accounting for debt, equity and equity-linked financial instruments. For each type of instrument, chapter 2 provides a decision tree to help navigate the various Topics that can apply.

The following table summarizes the respective chapters in this Handbook that may apply to different types of instruments.

Chapter	Debt (including convertible debt)	Equity shares (including convertible shares)	Equity-linked instruments
3. Debt	✓		
4. TDRs, debt modifications and extinguishments	✓	✓	✓
5. Equity		✓	✓
6. Distinguishing liabilities from equity	✓	✓	✓
7. SEC guidance on redeemable equity-classified instruments	✓	✓	✓
8. Contracts in an entity's own equity	✓	✓	✓
9. Hybrid instruments with embedded features	✓	✓	✓
10. Convertible instruments	✓	✓	✓
11. Comprehensive examples	✓	✓	✓

Read more: Chapter 2

Debt

Debt can take many forms, including commercial paper, loans, promissory notes, mortgages and bonds. Debt instruments can be simple (e.g. a term loan with a fixed interest rate) or complex (e.g. combined with equity instruments, or with embedded derivative features). Depending on the type of instrument, accounting for debt is addressed in Subtopics 470-10, 470-30, 470-40, 405-20 and 405-40.

Accounting for debt is summarized in the following table.

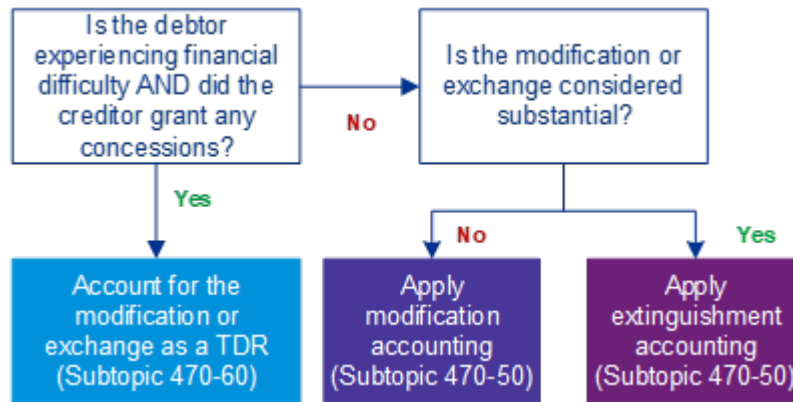
Initial measurement	Debt is initially recorded for the proceeds received at issuance, which generally equals its fair value. When debt is issued along with other freestanding instruments, the total proceeds received are allocated to each separate component issued as part of the transaction. Alternatively, a debtor can make a one-time irrevocable policy election at an instrument's inception to elect the fair value option under Subtopic 825-10 (financial instruments) or Subtopic 815-15 (embedded derivatives) and measure the debt at fair value. The fair value option election is made on an instrument-by-instrument basis.
Subsequent measurement	Unless a debtor is required or elects to subsequently measure debt at fair value, debt is generally subsequently measured at amortized cost. This means the value allocated to the debt instrument at initial recognition is classified as a liability and accreted or amortized to par value.
Classification	Classification of debt as current or noncurrent is grounded in the expectation of when and how the debtor will settle the obligation.

Additional recognition and measurement guidance applies to specific types of debt arrangements. If debt is share-settled, it may be in the scope of Topic 480 (see Distinguishing liabilities from equity, below).

Read more: Chapter 3

TDRs, debt modifications and extinguishments

A standard debt extinguishment, where there is no modification or refinancing, is accounted for under Subtopic 405-20. Complexity arises when a debt is modified or exchanged for new debt. How a modification or exchange of debt is accounted for is illustrated in the following decision tree.



Read more: Chapter 4

Equity

Equity represents an owner's interest in an entity and generally comprises amounts contributed by the owners plus earnings retained by the entity.

The accounting for equity-classified instruments and transactions is summarized in the following table.

Instrument / transaction	Accounting
Common shares	<ul style="list-style-type: none"> — Common shares with a par or stated amount: The common share account is credited for that par or stated amount, with the remaining proceeds credited to APIC. — Common shares with no par or stated amount: In our experience, the common share account is credited for the entire proceeds. Alternatively, an entity may credit APIC for the entire proceeds.
Preferred shares	<ul style="list-style-type: none"> — In our experience, the preferred share account is typically credited for the entire proceeds. — Alternatively, in some circumstances, if preferred shares are issued for an amount in excess of par, an entity may record the par value to the preferred shares account with the remaining proceeds credited to APIC.
Other equity-classified instruments	<p>APIC is recognized for other equity-classified instruments, which may include:</p> <ul style="list-style-type: none"> — forward contracts to issue an entity's own equity shares; and — warrants that allow the holder to purchase equity shares for a specified price (the exercise or strike price) during a specified period. <p>However, these instruments do not affect APIC if they are classified as liabilities under Topic 480 or otherwise</p>

Instrument / transaction	Accounting
	do not meet the conditions for equity classification in Subtopic 815-40.
Treasury shares	The cost of treasury shares is recorded as a reduction of shareholder's equity, unless the repurchased shares are immediately retired. In our experience, treasury shares are typically presented as a separate caption in equity – i.e. as a deduction from total equity.
Retained earnings	Retained earnings are an entity's accumulated earnings in excess of distributions to shareholders.

Read more: Chapter 5

Distinguishing liabilities from equity

Topic 480 establishes classification and measurement guidance for three classes of financial instruments with characteristics of both liabilities and equity. The three classes of financial instruments are:

Mandatorily
redeemable
financial
instruments

Obligations to
repurchase issuer's
equity shares by
transferring assets

Obligations to issue
a variable number
of shares

Topic 480 has two general requirements that must be met for the financial instrument to be in its scope:

- it is a freestanding financial instrument; and
- it reflects an obligation of the issuer.

If these requirements are met, along with certain other criteria, an entity is required to classify such instruments as liabilities.

The following table summarizes the initial and subsequent measurement guidance for instruments in the scope of Topic 480.

Instrument	Initial measurement	Subsequent measurement
Mandatorily redeemable instruments	Fair value	<ul style="list-style-type: none"> — Settlement amount and date fixed: Present value of amount to be paid at settlement, accruing interest cost using rate implicit at inception.
Physically settled forward contracts that obligate an issuer to purchase a fixed number of its equity shares for cash	Fair value of underlying shares at inception adjusted for any consideration or unstated rights or privileges	<ul style="list-style-type: none"> — Settlement amount or date varies: Amount of cash that would be paid under conditions specified in the contract if settlement occurred at the reporting date, recognizing change in that amount from the previous reporting date as interest cost.

Instrument	Initial measurement	Subsequent measurement
Obligations to issue a variable number of shares for a fixed monetary amount (e.g. stock-settled debt)	Fair value	Accreted value under Topic 835 (interest).
All other instruments	Fair value	Changes in fair value recognized in earnings, unless either Topic 480 or other accounting guidance specifies another measurement attribute.

Read more: Chapter 6

SEC guidance on redeemable equity-classified instruments

SEC registrants must classify certain redeemable equity instruments as temporary equity – outside of permanent equity on the balance sheet. The distinction between temporary and permanent equity allows financial statement users to identify which equity-classified instruments could result in future outflows of cash or other assets from the issuer that are outside the issuer’s control.

The SEC’s temporary equity guidance can be divided into the following parts.

Scope	Classification	Measurement
<ul style="list-style-type: none"> — Scoping applies at the level of the issuer and instrument — If an instrument for an issuer is out of scope, it is classified as permanent equity — If an instrument for an issuer is in scope, the classification guidance applies 	<ul style="list-style-type: none"> — Classification is determined through a holistic assessment of the in-scope features of that instrument (i.e. inclusive of bifurcated redemption features) — To be classified as permanent equity, redemption needs to be solely within the control of the issuer — Otherwise the instrument is classified as temporary equity 	<ul style="list-style-type: none"> — Specific measurement guidance exists for certain instruments (see section 7.4.20) — For all other instruments, initial measurement is at fair value — Specific guidance applies for subsequent measurement if the instrument is (i) currently redeemable or (ii) probable of becoming redeemable

Read more: Chapter 7

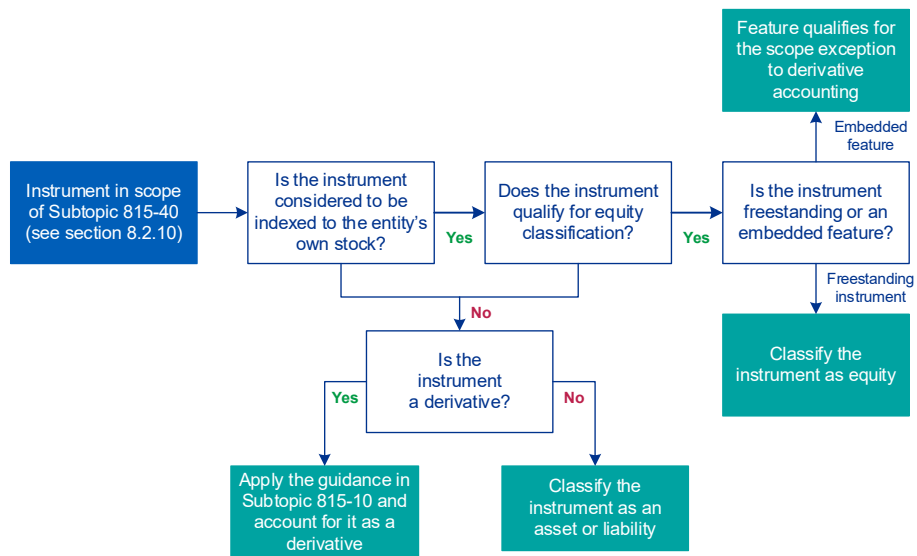
Contracts in an entity's own equity

Equity-linked financial instruments are instruments (or contracts) that are indexed to and potentially settled in an entity's own stock. To determine the accounting treatment of equity-linked financial instruments under Subtopic 815-40, they are analyzed against two criteria.

The indexation guidance determines whether an instrument is considered indexed to the entity's own stock.

The equity classification guidance determines whether the entity is required or is permitted to settle an instrument in its own shares (either physically or net in shares)

These two criteria and the additional steps in determining the appropriate accounting for an equity-linked financial instrument or feature are illustrated in the following decision tree.

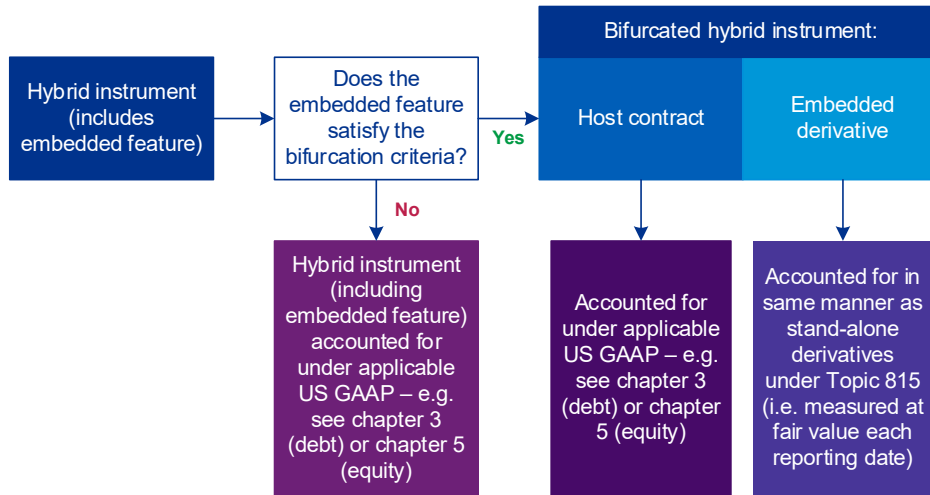


Read more: Chapter 8

Hybrid instruments with embedded features

A hybrid instrument is a financial instrument that has an embedded feature and does not, in its entirety, meet the definition of a derivative. How a hybrid instrument is accounted for depends on whether the embedded feature is separated (i.e. bifurcated) from the rest of the hybrid instrument. If the embedded feature is bifurcated, the rest of the instrument is called the host contract.

The bifurcated feature and the host contract are accounted for as follows.



Read more: Chapter 9

Convertible instruments

A convertible instrument is a debt or equity instrument with an embedded feature that requires or allows a holder to convert the instrument to equity shares of the instrument’s issuer.

Any one of three accounting models may apply to a convertible instrument.

Accounting model	Summary description
Models with separate accounting for the conversion feature	
Embedded derivative model	<ul style="list-style-type: none"> — Proceeds are allocated to the embedded conversion feature for its fair value, with remaining proceeds allocated to the host contract. — Subsequently, the embedded conversion feature is measured at fair value with changes reported in earnings.
Substantial premium model¹	Proceeds are allocated to equity for the premium.
Model without separate accounting for the conversion feature	
No proceeds allocated model	All proceeds are allocated to the entire instrument, which is classified as either a liability or equity – i.e. there is no separate accounting for the conversion feature initially or subsequently.
Note: 1. The substantial premium model does not apply to equity-classified convertible preferred shares.	

Read more: Chapter 10

Comprehensive examples

Chapter 11 provides comprehensive examples of instruments that require analysis under multiple chapters in this Handbook.

- Prepaid forward contracts on an entity's own shares
- Prepaid written put options on an entity's own shares
- Accelerated share repurchase programs
- Convertible debt with call spread transactions
- Debt automatically exchanged on next round of equity financing and otherwise convertible
- Special-purpose acquisition companies (SPACs)
- Excise tax on share repurchases
- Tranched preferred shares

Read more: Chapter 11

2. Roadmap to the guidance

Detailed contents

2.1 How the standard works

2.2 Understanding the instrument

- 2.2.10 What type of instrument was issued?
- 2.2.20 What is the unit of account?
- 2.2.30 What are the instrument's contractual terms?
- 2.2.40 How are proceeds allocated?

Questions

- 2.2.10 Does the accounting for an equity instrument follow its legal form?
- 2.2.20 Can an instrument be classified as equity if its legal form is debt?
- 2.2.25 Are convertible preferred equity certificates (CPECs) classified as debt or equity?
- 2.2.30 When is a financial instrument considered freestanding?
- 2.2.40 When are two freestanding instruments combined into one unit of account?
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- 2.2.60 Is a debt or equity instrument always accounted for as a single unit?
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2.3 Key considerations for identifying relevant guidance

- 2.3.10 Overview
- 2.3.20 Debt instruments
- 2.3.30 Equity shares
- 2.3.40 Equity-linked instruments

Question

- 2.3.10 What are some issues an entity considers in determining whether to elect the fair value option for a debt instrument?

2.4 Income taxes

2.1 How the standard works

The accounting for debt and equity instruments can be complex because determining the right accounting can require an entity to maneuver through multiple accounting standards to arrive at the appropriate accounting treatment.

The following table summarizes the guidance in this Handbook that may apply to different types of instruments.

Chapter / Literature	Debt (including convertible debt)	Equity shares (including convertible shares)	Equity-linked instruments
3. Debt Subtopics: 470-10 (overall debt), 470-30 (participating mortgage loans), 470-40 (product financing arrangements), 405-40 (joint and several liabilities), and 405-50 (supplier finance program obligations)	✓		
4. TDRs, other debt modifications and extinguishments Subtopics/Section: 470-20-40 (derecognition of debt with conversion and other options), 470-50 (modifications and extinguishments), 470-60 (TDRs by debtors), and 405-20 (extinguishment of liabilities)	✓	✓	✓
5. Equity Topic 505 (equity)		✓	✓
6. Distinguishing liabilities from equity Topic 480 (distinguishing liabilities from equity)		✓	✓
7. SEC guidance on redeemable equity classified instruments	✓	✓	✓
8. Contracts in an entity's own equity Subtopic 815-40 (contracts in an entity's own equity)	✓	✓	✓
9. Hybrid instruments with embedded features Subtopic 815-15 (embedded derivatives)	✓	✓	✓
10. Convertible instruments Subtopic 470-20 (debt with conversion and other options)	✓	✓	✓
11. Comprehensive examples	✓	✓	✓

2.2 Understanding the instrument

2.2.10 What type of instrument was issued?

The first step to accounting for a debt or equity instrument is to understand what type of instrument was issued.

Debt instruments	Debt instruments represent contractual obligations to transfer assets (or in certain cases issue equity shares) on fixed or determinable dates. A debt instrument may or may not have a stated interest rate. See chapter 3.
Equity shares (stock)	Equity shares represent an owner's interest in an entity. Equity shares are generally issued as common or preferred shares. See chapter 5.
Equity-linked instruments	Entities also issue other contracts (e.g. forwards, options, warrants) that provide the holder with the ability to either buy or sell the issuer's equity shares. These are referred to as equity-linked instruments. See chapter 8.



Question 2.2.10

Does the accounting for an equity instrument follow its legal form?

Interpretive response: Not necessarily. What can make the accounting for equity instruments (i.e. equity shares, including convertible shares, and equity-linked instruments) difficult is that some equity instruments contain characteristics of both debt and equity.

For example, a preferred share, which is an equity instrument in form, may contain a repayment provision, which is more consistent with a debt instrument. When an equity instrument has characteristics of debt, an entity may be required to classify it as a liability in the financial statements, subject to the same accounting requirements as a debt instrument. Further, an equity instrument may have features that warrant separate accounting (e.g. an embedded derivative), and an equity-linked instrument may be required to be accounted for as a derivative.

See also sections 2.3.30 and 2.3.40 for decision trees related to identifying relevant accounting guidance for equity shares and for equity-linked instruments, respectively.



Question 2.2.20

Can an instrument be classified as equity if its legal form is debt?

Interpretive response: No. Although US GAAP may require an instrument whose legal form is equity to be classified as liability (see Question 2.2.10), we

do not believe it is appropriate for an instrument whose legal form is debt to be classified as equity.



Question 2.2.25

Are convertible preferred equity certificates (CPECs) classified as debt or equity?

Background: Convertible preferred equity certificates (CPECs) are generally issued by companies domiciled in Luxembourg. Although CPECs are termed ‘preferred equity certificates’, they are typically deemed legal-form debt in Luxembourg. Therefore, payments or accruals made under the CPECs are, similar to interest payments, deductible under local tax laws. However, for US taxation purposes, CPECs are treated as equity.

Common CPEC features include the following.

- **Seniority.** CPECs typically rank senior to the issuer’s equity shares and pari passu with all other preferred equity instruments. However, they are subordinate to all other present and future obligations of the issuer, whether secured or unsecured.
- **Yield.** CPECs might have a stated yield.
- **Voting rights.** CPEC holders typically do not have any voting rights.
- **Redemption features.** CPECs are generally redeemable at the option of the issuer (i.e. are callable). Some CPECs are perpetual (i.e. do not have a specified maturity date). Others are required to be redeemed (i.e. they mature) at the end of their term, which is approximately 30 to 60 years from the date of issuance. However, any redemption is typically limited by availability of cash and cannot lead to insolvency of the issuer.
- **Conversion option.** CPECs are convertible into equity shares at the option of the issuer.
- **Creditor rights.** CPECs may be structured to grant creditor rights to holders in certain events, including the right to control of the board of directors or the right to force bankruptcy.

Interpretive response: There are certain features of CPECs that are similar to equity and other features that are similar to debt. We believe an instrument whose legal form is debt in the jurisdiction of issuance should generally be classified as debt, even if it is perpetual (see Question 2.2.20). As a result, CPECs that are legal-form debt in the jurisdiction issued are generally classified as debt.

2.2.20 What is the unit of account?

An entity might issue multiple instruments concurrently or in a similar timeframe. The accounting when multiple instruments are issued can depend on whether these instruments are viewed as separate freestanding instruments or as one combined instrument.

The unit of account when accounting for a freestanding financial instrument is generally that instrument. However, in certain situations there may be multiple units of account in a single freestanding instrument. In other situations, multiple freestanding instruments may have to be combined into one unit of account. The following are examples.

- An embedded feature that requires bifurcation as a derivative is treated as a separate unit of account – e.g. a call option in a debt instrument.
- Different components of an instrument may require separate accounting because they are classified differently – e.g. a conversion option in a debt instrument is sometimes classified as equity while the rest of the instrument is classified as debt.
- Two separate freestanding instruments may be treated as if they are one because accounting for them as a single unit of account more appropriately reflects their economic substance.


Therefore, identifying the different freestanding instruments and the appropriate unit of account for each is an important initial step in determining the accounting treatment for such instruments. The accounting guidance in section 2.3 is applied to each unit of account, which depends on the instrument’s type (section 2.2.10) and characteristics (section 2.2.30).

 **Question 2.2.30**
When is a financial instrument considered freestanding?

Interpretive response: A freestanding financial instrument generally is a financial instrument that is entered into either: [\[480-10 Glossary\]](#)

- separate and apart from any of the issuer’s other financial instruments or equity transactions; or
- in conjunction with another transaction but is legally detachable and separately exercisable.

For more guidance on determining if an instrument is freestanding or embedded, see section 6.3.

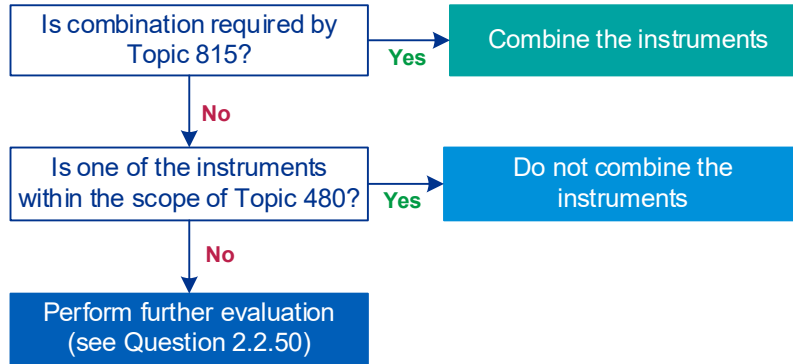
 **Question 2.2.40**
When are two freestanding instruments combined into one unit of account?

Interpretive response: Topic 815 requires that if two or more separate transactions are entered into in an attempt to circumvent its provisions, an issuer combines them and determines if the combined unit meets the definition of a derivative. Topic 815 provides indicators to consider in making that determination. See further discussion in Question 6.3.90. [\[815-10-15-9\]](#)

In contrast, Topic 480 prohibits the combination of two freestanding financial instruments unless it is required by Topic 815. The rationale behind the

prohibition is to prevent an entity from circumventing the requirements of Topic 480 by combining instruments. See further discussion in Question 6.3.80. [480-10-25-15]

The following decision tree explains the order in which Topics 815 and 480 are applied in evaluating separate financial instruments for combination.



Question 2.2.50

When an instrument is not combined with another instrument under Topic 815 and is not in the scope of Topic 480, how is it evaluated further?

Interpretive response: There is no specific guidance on whether to combine instruments when combination is not specifically required by Topic 815. To determine whether instruments should be combined in this case, we believe an important factor to consider is whether multiple instruments/contracts were issued instead of a single instrument to circumvent US GAAP.

Generally, there will have been no attempt to circumvent US GAAP if the instruments relate to different risks. One factor suggesting that instruments relate to different risks is that they have sufficiently different settlement dates.

Judgment should be exercised based on facts and circumstances in determining whether to combine multiple instruments.



Question 2.2.60

Is a debt or equity instrument always accounted for as a single unit?

Interpretive response: No. If a financial instrument is not a derivative itself, it may be necessary to separately account for certain of its features. For example:

- An embedded feature (e.g. embedded put option, call option or conversion option) may require separate accounting (bifurcation) as an embedded derivative (see chapter 9). The financial instrument in this case is called a

hybrid instrument, which comprises a host instrument (either debt or equity) and the embedded feature.

- An embedded conversion feature that is not bifurcated as an embedded derivative may require separate accounting as a component of equity (see chapter 10).

2.2.30 What are the instrument's contractual terms?

Because many instruments contain characteristics of both debt and equity, as well as other features that could be required to be accounted for separately, a careful understanding of the terms and conditions of an instrument is required to determine its appropriate accounting treatment.

The terms of a debt or equity agreement sometimes contain language that is subject to interpretation. Therefore, involvement of legal counsel is sometimes necessary to have a clear understanding of the terms of an agreement. Further, the contractual agreements may take various forms – e.g. a debt indenture, loan agreement with a lender, the articles of incorporation of the issuer, shareholders' agreements, standard contracts such as ISDA equity contracts, trade confirmation, registration payment agreements.

All of the relevant agreements for a particular instrument should be thoroughly analyzed.



Question 2.2.70

How does an entity identify the relevant terms and conditions when reviewing a debt or equity agreement?

Interpretive response: When an entity reviews a debt or equity agreement, the following questions can help it identify the key terms and conditions that will drive the accounting treatment.

- How long will the instrument be outstanding?
- What are the repayment terms for the instrument?
- If repayment is required, is payment required in cash, issuer's equity shares or some other medium?
- Is the instrument convertible into another type of instrument?
- If the instrument is convertible, what are the conversion terms?
- Does the instrument require interest or dividend payments?
- Does the instrument contain any governance rights, such as board seats?
- Does the instrument include covenants or default provisions?
- What happens to the instrument if the entity is acquired or liquidated?
- Does the instrument contain any registration rights?
- Were any other instruments issued at the same time?
- Does the instrument implicitly or explicitly refer to or incorporate by reference any other agreements, contracts or provisions?

For example, if the instrument is convertible into another type of instrument, it may require the conversion option to be accounted for separately. Or if a debt instrument has covenants, it may require the debt to be classified as a current liability, even if it is not due within the next 12 months.

2.2.40 How are proceeds allocated?

When there are multiple units of account, an entity determines the appropriate accounting for each unit of account based on the guidance in section 3.3. Proceeds are then allocated to each unit of account based on the relevant guidance. This includes consideration of the guidance in the respective chapters.

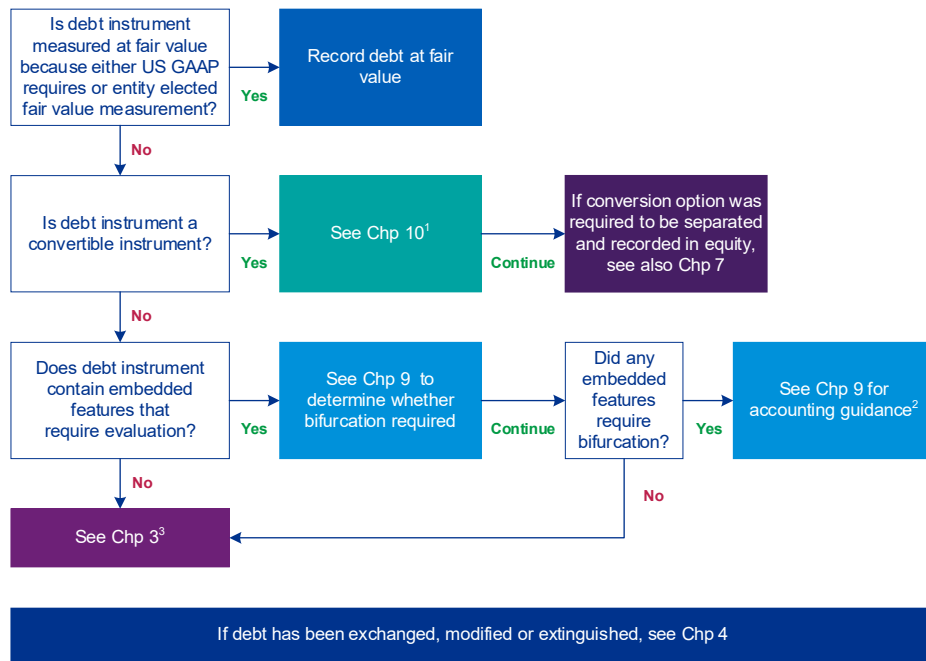
2.3 Key considerations for identifying relevant guidance

2.3.10 Overview

Determining the appropriate accounting guidance for a debt or equity instrument can be complex because some guidance applies only to certain types of instruments or only to instruments having certain features. This section includes decision trees that summarize the key considerations when determining the guidance that applies to each type of instrument.

2.3.20 Debt instruments

The following decision tree summarizes the key considerations when determining the guidance that applies to debt instruments.



Notes:

1. **Chapter 10** explains whether embedded features (including the conversion option) require bifurcation as embedded derivatives. Embedded derivatives are addressed in **chapter 9**. Further, the own equity scope exception from derivative accounting in **chapter 8** may apply to certain embedded derivatives (including conversion options).
2. **Chapter 9** includes considering the guidance in **chapter 3** when accounting for the debt instrument or the liability component (debt host).
3. Share-settled debt is the only form of debt in the scope of Topic 480. See section 3.2.20 in **chapter 3** for a description of share-settled debt. See **chapter 6** for measurement and classification guidance for share-settled debt.

Question 2.3.10
What are some issues an entity considers in determining whether to elect the fair value option for a debt instrument?

Interpretive response: Before making a fair value option election, an entity should consider the following, if applicable.

Whether bifurcation would otherwise be required under Topic 815.

An entity may make the fair value election under Subtopic 825-10 for any eligible debt instrument without first concluding that the instrument includes an embedded derivative requiring bifurcation.

However, an entity may prefer to elect the fair value option for a debt instrument only if it would otherwise be required to bifurcate an embedded derivative. In that case, even though the bifurcation analysis is not necessary for

election of the fair value option, an entity may want to perform the bifurcation analysis before electing the fair value option. [815-15-25-1(b)]

Chapter 9 provides guidance about embedded derivatives.

For convertible debt, whether the fair value option is available.

The fair value option is not available for financial instruments that, in whole or in part, are classified as a component of shareholders’ equity (including temporary equity). Therefore, an entity evaluates convertible debt to determine whether the conversion option requires separate accounting in equity (e.g. under the substantial premium model) before determining if the fair value option may be applied. [825-10-15-5(f)]

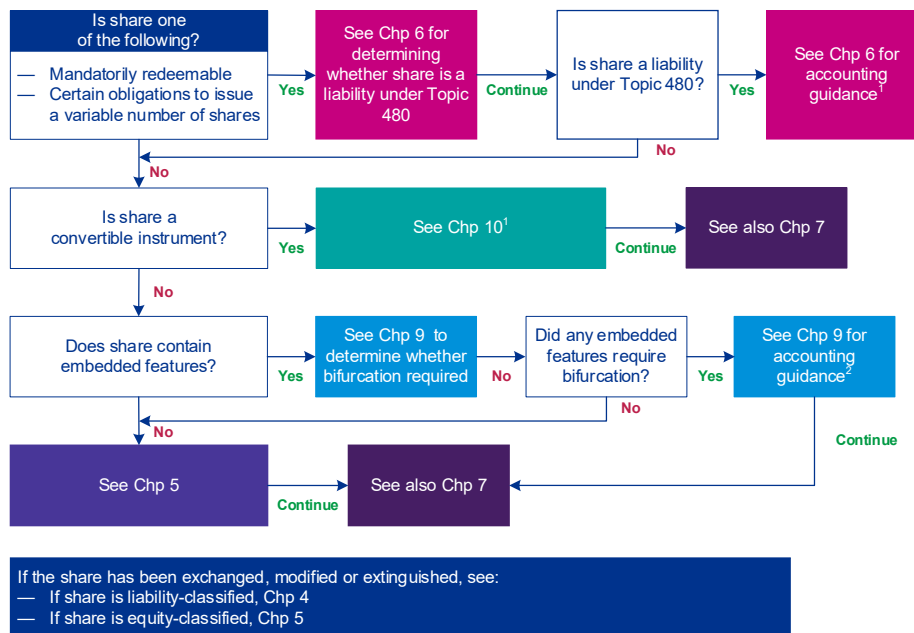
Chapter 10 provides guidance on convertible instruments.

Requirement to recognize instrument-specific credit risk changes in OCI.

When a financial liability is designated at fair value under the fair value option, an entity recognizes changes in fair value due to instrument-specific credit risk in AOCI with all other changes in fair value recognized in net income. Additional considerations apply in determining the changes in fair value due to instrument-specific credit risk when there are embedded features in the financial liability, and/or when the financial liability is denominated in a foreign currency.

2.3.30 Equity shares

The following decision tree summarizes the key considerations when determining the guidance that applies to equity shares.



Notes:

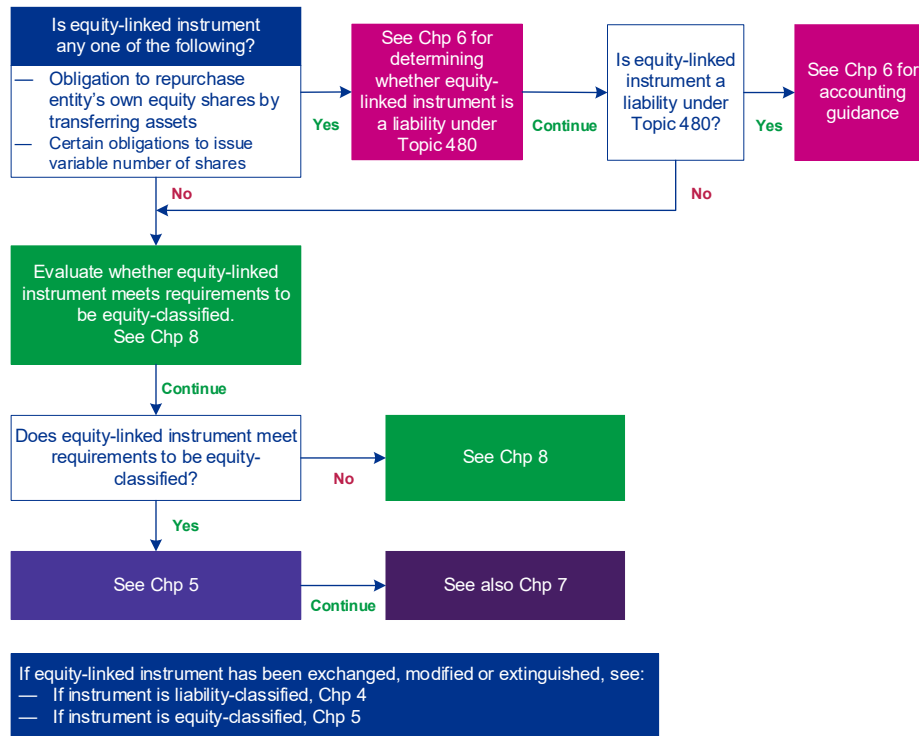
1. **Chapter 6** and **chapter 10** explain whether embedded features require bifurcation as embedded derivatives. Embedded derivatives are addressed in **chapter 9**.

Further, the own equity scope exception from derivative accounting in **chapter 8** may apply to certain embedded derivatives (including conversion options).

- The guidance in **chapter 5** should also be considered when accounting for the share (equity host).

2.3.40 Equity-linked instruments

The following decision tree summarizes the key considerations when determining the guidance that applies to an equity-linked contract.



In addition to the considerations in the decision tree, an equity-linked instrument that does not meet the requirements to be equity-classified is evaluated to determine whether it meets the definition of a derivative under Topic 815 (derivatives and hedging); see chapter 3 in KPMG Handbook, [Derivatives and hedging](#). If it does, the Topic 815 disclosures for derivative instruments apply.

2.4 Income taxes

The issuance of a debt or equity instrument has income tax consequences, which will differ depending on the jurisdiction. In the United States, temporary differences may arise due to differences in the tax and book basis of debt or equity instruments that are classified as liabilities. Further, there are tax provisions that affect the amount of interest expense that may be deducted. The tax consequences of a debt or equity issuance can be complex, and an

entity should be aware of the effect of these consequences on its financial statements.

This Handbook does not comprehensively address accounting for the income tax effects of debt and equity instruments. See KPMG Handbook, [Accounting for income taxes](#), for guidance.

3. Debt

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Item significantly updated in this edition: #

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3.1 How the standard works

While the term 'debt' is not actually defined in US GAAP, in general terms it represents a contractual obligation to transfer assets (or in certain cases issue equity shares) on fixed or determinable dates, and it may or may not have a stated interest rate.

Debt can take many forms, including commercial paper, loans, promissory notes, mortgages and bonds. Debt instruments can be simple (e.g. a term loan with a fixed interest rate) or complex (e.g. combined with equity instruments, or with embedded derivative features).

This chapter covers the initial recognition, initial and subsequent measurement, and presentation of debt instruments (nonconvertible) as addressed in Subtopics 470-10, 470-30, 470-40, and 405-40.



3.2 Key debt-related terms and types of debt instruments

3.2.10 Key debt-related terms

The following table includes descriptions and examples of commonly used terms for various types of debt instruments.

Key terms	Description	Example
Principal or par value or face value	The amount to be repaid (excluding interest) at maturity or over the term of the debt. Generally, this amount represents the total proceeds the debtor received at issuance (excluding any creditor fees or issuance costs). The terms principal, par value and face value are used interchangeably.	Bank issues a 10-year term loan of \$10 million with a stated interest rate of 8% to Debtor. Debtor incurs \$300,000 in issuance costs. The principal amount (par value or face value) of this debt arrangement is \$10 million, the amount due on maturity.
Maturity	A specific date or dates on which the debtor must repay the principal amount due.	The 10-year term loan was issued by Bank on January 1, Year 1. The date of maturity is 10 years from the date of issuance, or December 31, Year 10.
Stated interest rate	The interest rate under the terms of the debt arrangement. The stated interest rate can be fixed or variable (with a spread added) and is applied to the principal balance of the debt when calculating interest payments.	Under the terms of the loan issued by Bank, interest is paid by Debtor annually on December 31. The annual interest is \$800,000: principal balance of \$10 million × stated interest rate of 8%.
Market rate	The interest rate being offered most commonly by banks/creditors as of the current date. The market rate varies based on the amount, duration and type of debt instrument being issued.	Examples include US Treasury Bill rate, Secured Overnight Financing Rate (SOFR) and longer term US Treasury bond yields.
Paid-in-kind (PIK) interest	Required under the terms of the arrangement or at the option of the debtor, interest PIK is paid through the issuance of additional securities (i.e. additional principal) instead of cash.	Changing the terms of the loan issued by Bank, interest is not paid annually. Instead, in Year 1, Debtor owes annual PIK interest of \$800,000, which increases the principal amount due to \$10,800,000. In Year 2, Debtor owes PIK interest of \$864,000, which increases the

Key terms	Description	Example
		principal amount due to \$11,664,000 and so on.
SOFR	<p>The Secured Overnight Financing Rate is an interest rate published daily by the Federal Reserve Bank of New York. SOFR is widely used as a benchmark interest rate, indicating the cost of overnight cash borrowing that is collateralized by US Treasury securities.</p> <p>Term SOFR is published daily by the Chicago Mercantile Exchange and provides forward-looking rates.</p>	<p>A US dollar denominated bond has a quarterly interest payment based on a variable interest rate of SOFR plus a margin of 15 basis points.</p> <p>Debtor (bond issuer) determines the interest rate each quarter based on the current three-month US dollar term SOFR rate.</p>
Basis points	A basis point is a unit of measure for interest rates or percentages, such that 1% is equivalent to 100 bps.	If SOFR is 2%, the interest rate used to calculate the interest payment on the bond issued by Debtor for the period is 2.15% – 15 basis points equals 0.15%.
Carrying amount	<p>Debt is generally¹ measured on the balance sheet at its amortized cost, which is its carrying amount. Premiums, discounts and debt issuance costs are presented as part of the net carrying amount of the debt on issuance.</p> <p>Subsequently, premiums are amortized from the carrying amount of the debt as a reduction to interest expense over the term. Discounts and debt issuance costs are accreted into the carrying amount of the debt and included in interest expense.</p> <p>Note:</p> <p>1. A debtor may make an irrevocable election at inception to measure certain financial liabilities using the fair value option under Topic 825.</p>	<p>The bond issued by Debtor (par value of \$1,000) is issued at a premium, with total proceeds received of \$1,134. Debt issuance costs of \$50 are incurred. The carrying amount at the date of issuance is \$1,084:</p> <ul style="list-style-type: none"> — par value: \$1,000 — plus premium: \$134 — less issuance costs: \$50. <p>Each subsequent period, through the date of maturity, Debtor amortizes the net premium (net of debt issuance costs, \$84) such that the carrying amount of the debt is the par value of \$1,000 at maturity.</p>
Discount	<p>A debt instrument may be priced at a discount if the prevailing market rate is higher than the stated interest rate.</p> <p>The instrument is issued at a discount to offer an effective</p>	Debtor issues a 10-year bond with a par value of \$1,000 and a stated interest rate of 8%; the market rate at date of issuance is 9%.

Key terms	Description	Example
	interest rate equal to the prevailing market rate.	The bond is priced at \$936, which represents a discount of \$64.
Premium	A debt instrument may be priced at a premium if the stated interest rate is higher than the market rate. The instrument is issued at a premium to offer an effective interest rate equal to the prevailing market rate.	Debtor issues a 10-year bond with a par value of \$1,000 and a stated interest rate of 10%; the market rate at date of issuance is 8%. The bond is priced at \$1,134 which represents a premium of \$134.
Debt issuance costs	Debt issuance costs represent costs directly attributable to issuing the debt. This generally includes any third-party accounting, legal or underwriting costs. Debt issuance costs are presented as part of the initial carrying amount of the debt. They are subsequently accreted into the carrying amount of the debt over its term. See section 3.4.	Debtor issues a 10-year bond with a par value of \$1,000 and a stated interest rate of 8% (which represents the current market rate). Third-party fees incurred to issue the bond are \$50. The \$50 of debt issuance costs are netted against the carrying amount of the debt; therefore, the initial carrying amount of the debt is \$950.
Embedded features	Embedded features are terms that introduce variability into a contract that would have otherwise been fixed. These features may require additional accounting considerations when recording the transaction. See chapter 9.	Debtor issues a 10-year bond with a par value of \$1,000 for \$1,100; the bond has a stated interest rate of 5%. Creditor has the right to demand repayment at December 31, Year 5. The ability of Creditor to demand repayment (or 'put' the bond back to Debtor) is a put option. Similarly, if Debtor has the right to repay the bond at a specified date before maturity, such feature is a call option.
Effective interest rate	The rate of return implicit in the arrangement, representing the contractual interest rate adjusted for any net deferred issuance costs, premiums or discounts existing at the origination or acquisition of the loan. The effective interest rate may differ from the stated interest rate and is used for accounting purposes only. Regardless of the effective interest rate, the	Debtor issues a 10-year bond with a par value of \$1,000 at a discount of \$64; the bond has a stated interest rate of 8%. Debtor incurs issuance costs of \$50. The effective interest rate is 9.84% (rounded), which represents the stated rate of 8% adjusted for the additional interest expense recorded over the term of the debt due to the accretion of the

Key terms	Description	Example
	debtor is required to pay interest based on the stated interest rate. The effective interest rate can be calculated using an IRR spreadsheet formula.	deferred discount and debt issuance costs.
Effective interest method	The amortization of a premium or accretion of a debt discount or debt issuance costs are required to be recorded each period using the effective interest method. The effective interest method yields a constant rate of interest over the term of the debt, by applying the effective interest rate to the carrying amount of the debt each period to record total interest expense.	The \$1,000 bond issued by Debtor at a discount of \$64, with related issuance costs of \$50, has an initial carrying amount of \$886: $\$1,000 - \$64 - \$50$. The effective interest rate of 9.84%. Interest expense in Year 1 is \$87: <ul style="list-style-type: none"> — \$80 stated interest payable by Debtor; plus — \$7 accretion of the discount/issuance costs into the carrying amount of the debt and interest expense. The carrying amount of the debt for Year 2 increases by the accretion of \$7 from Year 1. Total interest expense increases each year as the constant effective interest rate of 9.84% is applied to the (increasing) carrying amount of the debt. Over the bond's term, its carrying amount increases from its initial amount of \$886 to the par value of \$1,000 due at maturity.

3.2.20 Types of debt instruments

The following table lists common types of debt instruments.

Type of debt	Description	Example
Term loan	A loan for a determined amount that has specific repayment and interest terms.	A five-year loan for \$5 million, bearing interest at SOFR, with interest payments due quarterly.
Line of credit and revolving credit arrangement	A credit arrangement (long- or short-term in nature) allowing for the debtor to draw down	Revolving credit agreement permitting Debtor to borrow up to \$50 million over a five-

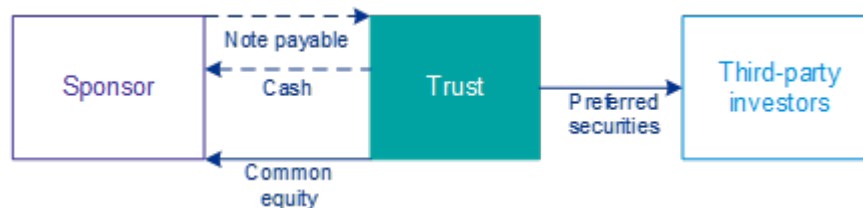
Type of debt	Description	Example
	and repay funds during the term of the arrangement.	year period, bearing interest at SOFR plus a margin. Debtor can continually borrow and repay available funds as needed during the term of the credit arrangement.
Zero coupon bond	A debt instrument with a zero percent stated interest rate and no payment until maturity. The bond is issued at a discount to the par value at the date of issuance, paying no interest over the life of the debt. At maturity, the bond is redeemable for par value. The investor's return is the difference between the discounted cost and the par value paid at maturity.	A bond issued for \$70 with a \$100 par value payable on maturity in five years. No interest is paid during the five-year term.
Share-settled debt	A debt instrument is considered share-settled when the debtor must or may settle the obligation by issuing a variable number of equity shares (with a fixed monetary value). The measurement and classification guidance in Topic 480 determines: <ul style="list-style-type: none"> — the appropriate carrying amount of the instrument; and — whether the debt should be classified as a liability or as equity (see chapter 6). 	Debt issued for proceeds of \$1 million that Debtor will contractually satisfy at the end of one year by issuing a variable number of its common shares with a value of \$1,100,000.
Indexed debt	Debt with embedded components that provide for returns that are indexed to an underlying other than an interest rate, such as the price of a commodity (see section 3.7.10).	Debt issued for \$1 million with an initial stated interest rate of 8%, adjusted based on changes in the price of gold.
Inflation-indexed debt	Debt that mitigates the risk of inflation to the holder by making adjustments to the principal based on changes to the consumer price index (CPI).	Debtor issues an inflation bond with an initial principal of \$1,000 at a stated rate of interest of 8%. The bond is indexed to inflation, such that if the CPI increases by 5%, the principal increases by 5%.
Increasing-rate debt	Debt instrument where the stated interest rate increases	Debtor issues five-year debt for \$1 million with an initial

Type of debt	Description	Example
	(under the terms of the agreement) if the maturity date is extended at the option of the debtor or the debt is not paid in full by a specified date (see section 3.7.50).	fixed interest rate of 5%. If Debtor does not pay the debt in full after the third year, the fixed interest rate increases to 6%. If the debtor does not pay the debt in full after four years, the fixed interest rate increases to 10%.
Convertible debt	Debt with an embedded feature that provides one of the parties (usually the creditor) an option to convert the debt into the debtor's equity securities, usually on or before a specified date/event and at a specified ratio. See chapter 10 for further discussion of convertible instruments and chapter 4 for modifications of convertible debt.	Debtor issues \$1,000 par value notes with a 3% stated interest rate that are convertible into 100 common shares of Debtor at the option of Creditor at any time during the life of the notes.
Perpetual debt	Debt with no maturity date, with the creditor receiving interest payments in perpetuity, or until such time that it decides to redeem the debt or the debtor elects to call the debt (after a specified period of time has elapsed).	Debtor issues a \$1,000 par value perpetual bond, with a stated interest rate of 5%, for \$900. The bond has no maturity date; however, Debtor can elect to call the bond any time after five years.
Exchangeable debt	A debt instrument where the debtor typically has the option to settle the debt with shares of another entity (different from the debtor) or with cash equal to the fair value of such shares.	Debtor issues exchangeable debt with a principal amount of \$1,000, maturing in five years, and with a stated interest rate of 5%. At maturity, Debtor will settle the debt by issuing the holder a certain number of shares of DEF Corp. (a publicly traded entity that Debtor does not control). The number of shares delivered upon settlement will depend on the fair value of the shares on the settlement date.
Term-extending debt	A debt instrument containing a term-extending feature that allows the term of the debt arrangement to be extended upon election by the debtor or the creditor, or upon the triggering of a specified event. A term-extending feature is analyzed under Topic 815 to	Debtor issues debt with a principal amount of \$1,000, maturing in three years, and with a stated interest rate of 6%. The arrangement's terms state that if SOFR increases by 250 bps at any point during the initial three-year term, the

Type of debt	Description	Example
	determine if it is an embedded derivative requiring bifurcation.	term will automatically extend by two years at the same interest rate of 6%.
Debt that is automatically exchanged on next round of financing and otherwise convertible (a bridge loan)	<p>A debt instrument that is short-term in nature and is used by the debtor to provide liquidity until a more permanent financing solution is available.</p> <p>A bridge loan frequently includes embedded features, such as:</p> <ul style="list-style-type: none"> — conversion feature (see ‘Convertible debt’ row above); — contingent exchange feature (see Question 10.2.50); and — put option exercisable upon a change in control. 	<p>Debtor issues debt with a principal amount of \$1,000, maturing in six months, with a 15% stated interest rate.</p> <p>The debt is convertible into 100 shares of an existing class of Debtor’s preferred shares at the option of Creditor at any time during the life of the debt. If Debtor issues a new class of preferred shares during the life of the debt, the debt will automatically be exchanged into those shares at a 20% discount to the issuance price. Further, Creditor can require Debtor to immediately repay the debt.</p> <p>For further discussion, see Example 11.6.10.</p>

Question 3.2.10**
How are trust preferred securities reported in the financial statements of a sponsor to a limited purpose trust that it does not consolidate?

Background: In a typical trust preferred securities structure, a sponsor (usually a bank), establishes a limited purpose trust (Trust) by contributing cash in exchange for all of the Trust’s common equity. The purpose of the Trust is to issue trust preferred securities to third-party investors and use the proceeds of the issuance to extend an equal amount of financing to the sponsor (Sponsor). The financing to the sponsor is typically in the form of junior subordinated debentures, notes or other instruments that have stated maturity dates (the ‘notes’).



The notes are Trust’s only assets. When Sponsor makes its interest payments on the notes, Trust distributes the cash to the holders of the trust-preferred securities. The trust-preferred securities must be redeemed on maturity of the notes.

Sponsor generally does not have a variable interest in – and does not consolidate – Trust because Sponsor both creates the variability and absorbs it; see Question 3.4.20 in KPMG Handbook, [Consolidations](#).

Interpretive response: The entity (Sponsor) reports the note payable issued to Trust as debt instruments in its balance sheet; it does not report the trust-preferred securities issued by Trust to third-party investors on its balance sheet. Further, it evaluates any derivatives embedded in the debt instruments (e.g. embedded call options) to determine if they require bifurcation and separate accounting from the debt host (see chapter 9).

3.3 Initial measurement of issued debt

3.3.10 Overview

Accounting for a debt issuance depends on the following.

- Nature of the consideration. Debt can be issued in exchange for cash; a future right or privilege; property, goods or services; or a combination of each of these items. Section 3.3.30 discusses future rights and property, goods or services.
- Difference between the stated and market interest rate. If the stated interest rate does not reflect the market interest rate for the debtor at the time of issuance, the debt is issued at a premium or discount. Section 3.4 discusses debt premiums or discounts.

Generally, the fair value of the debt instrument equals the proceeds received at issuance. However, this is not always the case (see Question 3.3.10).



Example 3.3.10 Debt issued solely for cash

On January 1, Year 4, Debtor issues a 20-year bond with a par value of \$1,000 for \$1,000 in cash proceeds. The fair value of the debt instrument on January 1, Year 4 is \$1,000.

Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	1,000	
Bond payable		1,000
<i>To recognize issuance of bond.</i>		



Question 3.3.10

What are common situations in which a debt's fair value differs from the issuance proceeds?

Interpretive response: The fair value of debt is typically based on the present value of the debt's cash flows. This present value may not always equal the consideration received, such as when:

- the debt instrument includes stated or unstated rights and privileges (see section 3.3.30);
- the debt is issued in a noncash exchange for property (see section 3.3.30); and/or
- the debt is issued with other securities (see section 3.3.20).

In these circumstances, the debtor records the issuance of the debt under the applicable US GAAP using one of the allocation methods described in section 3.3.20.

Further, a debtor can make a one-time irrevocable policy election at an instrument's inception to elect the fair value option under Subtopic 825-10 (financial instruments) or Subtopic 815-15 (embedded derivatives) and measure the debt at fair value. The fair value option election is made on an instrument-by-instrument basis. [825-10-45-5]

Electing the fair value option to measure debt could result in recording an initial amount different from the proceeds received.

3.3.20 Allocating proceeds when debt is issued with other instruments



Excerpt from ASC 470-20

> Debt Instruments with Detachable Warrants

25-2 Proceeds from the sale of a debt instrument with stock purchase warrants (detachable call options) shall be allocated to the two elements based on the relative **fair values** of the debt instrument without the warrants and of the warrants themselves at **time of issuance**. The portion of the proceeds so allocated to the warrants shall be accounted for as paid-in capital. The remainder of the proceeds shall be allocated to the debt instrument portion of the transaction. This usually results in a discount (or, occasionally, a reduced premium), which shall be accounted for under Topic 835.

25-3 The same accounting treatment applies to issues of debt instruments (issued with detachable warrants) that may be surrendered in settlement of the exercise price of the warrant. However, if stock purchase warrants are not detachable from the debt instrument and the debt instrument must be surrendered to exercise the warrant, the two instruments taken together are

substantially equivalent to a convertible debt instrument and the accounting specified in paragraph 470-20-25-12 shall apply

> Debt Instruments with Detachable Warrants

30-1 The allocation of proceeds under paragraph 470-20-25-2 shall be based on the relative **fair values** of the two instruments at **time of issuance**.

30-2 When detachable warrants (detachable call options) are issued in conjunction with a debt instrument as consideration in purchase transactions, the amounts attributable to each class of instrument issued shall be determined separately, based on values at the time of issuance. The debt discount or premium shall be determined by comparing the value attributed to the debt instrument with the face amount thereof.

If a debtor issues debt along with other freestanding instruments, the total proceeds received are allocated to each separate component issued as part of the transaction.



Question 3.3.20

What methods are used to allocate proceeds from a debt issuance to the separate components of the issuance transaction?

Interpretive response: In our experience, there are two basic allocation methods, depending on the circumstances (see Question 3.3.30).

Relative fair value method	Residual method ('with and without' method)
<p>The debtor independently determines the fair value of each separate component issued in the financing transaction.</p> <p>It then allocates the total transaction proceeds to those components on a relative fair value basis.</p>	<p>Independent determinations are made of the fair values of each separate component issued in the financing transaction.</p> <p>One or more of the separate components are recorded at fair value and one or more of the separate components are recorded at the residual value – i.e. the difference between the proceeds received and the proceeds allocated to components recorded at fair value.</p> <p>The residual is allocated on a relative fair value basis to the remaining components issued.</p>



Question 3.3.30

What allocation method is appropriate when debt is issued with other instruments for cash proceeds?

Interpretive response: A debtor is required to use the allocation method prescribed by the applicable US GAAP specific to the various debt instruments issued. Therefore, the allocation method is not an accounting policy election and depends on the type and/or classification of the various instruments issued.

The allocation method depends on whether subsequent remeasurement is at fair value – i.e. on whether US GAAP requires or permits (through a fair value election) an instrument to be subsequently remeasured at fair value. If an instrument is to be subsequently remeasured at fair value, it is presumed that initial measurement is also at fair value.

- **No instruments are remeasured at fair value.** When two or more instruments are issued in a transaction and none of them will be remeasured at fair value, the relative fair value method is used to allocate the proceeds between those instruments.
- **Some instruments are remeasured at fair value.** When two or more instruments are issued in a transaction and some instruments will be remeasured at fair value, the proceeds are first allocated to the instruments recorded at their fair value. Next, the residual method is used to allocate the proceeds to the instrument(s) that are not remeasured at fair value. If there are multiple instruments not remeasured at fair value, the relative fair value method is used to allocate the residual proceeds among them.

Below are examples of specific debt instruments (fair value option is not elected) and references to the prescribed allocation method – based on its subsequent measurement requirements.

Type of debt transaction	Subsequent measurement requirements	Likely allocation method	ASC reference
Debt with detachable equity-classified stock purchase warrants	Presumes US GAAP does not require subsequent fair value measurement for either instrument	Relative fair value method	470-20-25-2, 470-20-30-1
Debt with liability-classified detachable stock purchase warrants	Presumes US GAAP requires subsequent fair value measurement of the warrants only	Residual method	Topic 815 ¹
Mandatorily redeemable instrument issued with a detachable liability-classified stock warrant ²	Presumes US GAAP requires subsequent fair value measurement for the warrants only	Residual method	480-10-30-1, 480-10-55-63, Topic 815

Type of debt transaction	Subsequent measurement requirements	Likely allocation method	ASC reference
Mandatorily redeemable instrument issued with a detachable equity-classified stock warrant ³	Presumes US GAAP does not require subsequent fair value measurement for either instrument	Relative fair value method	480-10-30-1

Notes:

1. When a debtor issues debt with liability-classified stock purchase warrants, we believe the residual method should be used so that the warrants are recognized at fair value at issuance and the residual proceeds are allocated to the debt. This is similar to the method required for a bifurcated embedded derivative.
2. While Topic 480 requires initial fair value measurement of mandatorily redeemable instruments, we believe the detachable warrants should be recognized at fair value at issuance, and the residual proceeds should be allocated to the mandatorily redeemable financial instruments. This method avoids an immediate income statement impact upon recording the transaction because the warrants are required to be subsequently remeasured at fair value. Recognition of the discount (or premium) on the mandatorily redeemable financial instruments attributable to this allocation becomes a component of the interest rate implicit in the instrument and becomes incorporated within the application of the subsequent measurement guidance related to mandatorily redeemable financial instruments (see section 6.9.10).
3. While Topic 480 requires initial fair value measurement of mandatorily redeemable instruments, we believe entities generally should allocate the proceeds between the mandatorily redeemable financial instruments and equity-classified detachable warrants on a relative fair value basis; this is consistent with the provisions of Subtopic 470-20. Recognition of the discount (or premium) on the mandatorily redeemable financial instruments attributable to this allocation becomes a component of the interest rate implicit in the instrument and becomes incorporated within the application of the subsequent measurement guidance related to mandatorily redeemable financial instruments (see section 6.9.10).



Example 3.3.20

Allocation of proceeds when debt is issued with another instrument

Scenario 1: Allocation using relative fair value method

On January 1, Year 4, Debtor issues the following instruments for total proceeds of \$100,000:

- a five-year, 7%, \$100,000 par value bond; and
- detachable warrants to purchase its shares of common shares.

The stock purchase warrants meet the requirements in Subtopic 815-40 (see chapter 8) and qualify to be equity-classified. Debtor does not elect the fair value option for the issued bond. Therefore, neither instrument is subsequently remeasured at fair value and the proceeds are allocated on a relative fair value basis. At issuance, the fair value of the bond is \$98,000, and the fair value of the warrants is \$2,700.

Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash ¹	100,000	
Bond payable – Discount ²	2,681	
APIC (warrants) ³		2,681
Bond payable (par value) ²		100,000
<i>To recognize issuance of bond.</i>		
Notes:		
1. Cash proceeds received upon issuance of the bond.		
2. Total proceeds are allocated to debt based on the relative fair value as: Debt: $\$100,000 \times [\$98,000 \div (\$98,000 + \$2,700)] = \$97,319$. The difference between the par value of the bond and the fair value is recorded as a debt discount.		
3. $\$100,000 \times [\$2,700 \div (\$2,700 + 98,000)]$.		

Scenario 2: Allocation using residual method

The facts are the same as in Scenario 1, except the warrants do not meet the requirements in Subtopic 815-40 and therefore are initially and subsequently accounted for at fair value.

Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	100,000	
Bond payable – Discount ¹	2,700	
Derivative liability (warrants) ²		2,700
Bond payable (par value)		100,000
<i>To recognize issuance of bond.</i>		
Notes:		
1. Total proceeds are allocated to the debt based on the residual value (difference between the total proceeds received of \$100,000 and the \$2,700 fair value of the warrants): \$97,300. The resulting discount (\$2,700) is recorded for the difference between the par value and the allocated proceeds. As a result, \$97,300 is recorded as a bond payable on the balance sheet.		
2. Because the warrants do not meet the requirements in Subtopic 815-40, they are recorded at their fair value of \$2,700.		



Question 3.3.35

How are proceeds allocated when debt issued with another instrument also has separate components recognized?

Interpretive response: We believe a debtor should follow a two-step process of allocating the proceeds.

- Allocate the proceeds between the debt and the other instrument.
- Use the proceeds allocated to each instrument to determine the allocation to the components of that instrument – e.g. between an embedded derivative that requires bifurcation and the host contract.

Each of those allocations is performed based on the guidance in Question 3.3.30 – i.e. allocations are based on the subsequent measurement requirements of the instruments and components.



Example 3.3.25

Debt with an embedded derivative requiring bifurcation is issued together with a warrant

On January 1, Year 5, Debtor issues the following instruments for total proceeds of \$100,000.

- Five-year, 7%, \$100,000 par value bond. The bond contains an equity-indexed feature that is payable in cash if it is in-the-money at maturity of the debt and requires bifurcation.
- Detachable warrants to purchase its common shares.

At issuance, the fair values are as follows.

Instrument	Fair value
Bond (including the equity-indexed feature)	\$98,000
Equity-indexed feature (put option)	500
Warrants	2,700

Debtor does not elect the fair value option for the issued bond.

Scenario 1: Warrants qualify to be equity-classified

Debtor first allocates the total proceeds of \$100,000 between the bond and detachable warrants. Because the warrants are equity-classified, this allocation is performed using the relative fair value method.

Instrument	Fair value	Relative fair value % ¹	Allocated proceeds ²
Bonds payable	\$ 98,000	97%	\$ 97,319
Detachable warrants	2,700	3%	\$2,681
Total	\$100,700	100%	\$100,000

Notes:

1. Fair value of instrument ÷ Total fair value (\$100,700).
2. Relative fair value % × Total proceeds (\$100,000).

Next, Debtor allocates the \$97,319 proceeds allocated to the bond between its equity-indexed option and debt host contract components. Because the equity-indexed option is bifurcated as an embedded derivative and remeasured at fair value, the proceeds are allocated using the residual method. Therefore, they are first allocated to the put option component for its fair value (\$500) with residual proceeds allocated to the debt host component (\$96,819).

Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	100,000	
Bond payable – Discount ¹	3,181	
APIC (warrants)		2,681
Derivative liability		500
Bond payable (par value)		100,000
<i>To recognize issuance of bond.</i>		
Note:		
1. The difference between the par value of the bond (\$100,000) and the residual proceeds allocated to the debt host contract component (96,819).		

Scenario 2: Warrants do not qualify to be equity-classified (i.e. are liability-classified)

Debtor first allocates the total proceeds of \$100,000 between the bond and detachable warrants. Because the warrants are remeasured at fair value, this allocation is performed using the residual method. Therefore, the total proceeds are first allocated to the warrants for their fair value (\$2,700) with residual proceeds allocated to the debt host component (\$97,300).

Next, Debtor allocates the \$97,300 proceeds allocated to the bond between its put option and debt host contract components. Because the put option is remeasured at fair value, the proceeds are allocated using the residual method. Therefore, they are first allocated to the put option component for its fair value (\$500) with residual proceeds allocated to the debt host component (\$96,800).

Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	100,000	
Bond payable – Discount ¹	3,200	
Warrant liability		2,700
Derivative liability		500
Bond payable (par value)		100,000
<i>To recognize issuance of bond.</i>		
Note:		
1. The difference between the par value of the bond (\$100,000) and the residual proceeds allocated to the debt host contract component (96,800).		



Question 3.3.40

How are proceeds allocated if the fair value of the financial liability component required to be measured at fair value exceeds total proceeds?

Interpretive response: The SEC staff has provided its views on situations in which the fair value of the financial liability component that is required to be measured at fair value exceeds the total proceeds received for a hybrid instrument. [\[2014 AICPA Conf\]](#)

The staff noted that although such circumstances do not appear to be financially advantageous, there could be other substantive reasons a debtor would enter into this type of arrangement. For example, a debtor may want to establish a beneficial relationship with a creditor (investor), or the debtor could be in financial distress and require financing. The staff indicated that while US GAAP provides allocation guidance for certain types of transactions, judgment is required to determine the allocation of proceeds when fair value of the financial liability component exceeds the proceeds received.

The staff gave an example in which a debtor (in an effort to align itself with a specific investor) issues convertible debt (hybrid instrument) at par. The debtor is required to bifurcate the embedded conversion feature (the financial liability) and measure it at fair value. However, the embedded conversion feature's fair value exceeds the total net issuance proceeds received for the convertible debt. In this example, the staff indicated that a debtor should:

- verify that the fair value of the financial liabilities is consistent with the fair value measurement principles in Topic 820;
- if the fair value measurement is appropriate, evaluate whether the transaction was conducted at arm's length – including an assessment of whether the parties involved are related parties under Topic 850; and
- if the transaction was conducted at arm's length between unrelated parties, determine if there are any other rights or privileges as part of the transaction that meet the definition of an asset under other applicable guidance.

If there are no additional rights or privileges identified, the embedded derivative is measured at fair value and the excess of the fair value over the total proceeds is recognized as a loss in earnings. The staff further indicated that given the unique nature of such transactions, the debtor should disclose the nature of the transaction, including the reasons why it entered into the transaction and the benefits received.

The staff acknowledged that a debtor may reach a different conclusion when a transaction is conducted between related parties or is not at arm's length. The staff cautioned that such fact patterns require significant judgment and encouraged consultation with the staff.

3.3.30 Issuance of debt in exchange for a noncash asset or combination of cash and a noncash asset

If a debtor issues debt and the consideration include cash and/or assets other than cash, it determines the initial carrying amount of the debt based on the fair value of the various components of the transaction.



Question 3.3.50

What is the initial carrying amount of debt issued in exchange for a noncash asset or combination of cash and a noncash asset?

Interpretive response: When recording debt issued in a noncash exchange for property, goods or services, a debtor applies these guidelines.

If fair value of property, goods or services is observable	If fair value of property, goods or services is not observable
<p>The debtor records: [835-30-25-10]</p> <ul style="list-style-type: none"> — the debt at the fair value of the property, goods or services; and — a premium or discount for any difference between the par value of the debt and the fair value of the property, goods or services. <p>The fair value of the property, goods or services is determined using the guidance in Topic 820. Evidence of fair value may include cash transactions of the same or similar type, quoted market prices, independent appraisals and other available evidence.</p>	<p>If the fair value of the property, goods or services is not observable, or the fair value of the debt is more clearly determinable, the debtor records: [835-30-25-9]</p> <ul style="list-style-type: none"> — the debt at the present value of the cash flows using the market interest rate at the issuance date; and — a premium or discount for any difference between the par value of the debt and the present value of the debt.



Example 3.3.30

Debt issued in a noncash exchange

Scenario 1: Fair value of goods is observable

Debtor purchases inventory from Supplier in exchange for a three-year \$50,000 note with a stated interest rate of 6%. The inventory has a fair value of \$45,000 based on observable market prices for identical products. Debtor recognizes the note based on the fair value of the inventory because this value is observable. Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Inventory	45,000	
Note payable – Discount ¹	5,000	
Note payable		50,000
<i>To recognize purchase of inventory for note payable.</i>		
Note:		
1. Par value of debt (\$50,000) – Fair value of inventory (\$45,000).		

Scenario 2: Fair value is not observable

Debtor purchases custom-built equipment for use in its manufacturing operation from Supplier in exchange for a three-year \$50,000 note with a stated interest rate of 4%. The market interest rate for debt with similar terms and credit quality is 8%. The fair value of the equipment is not readily determinable because there is no quoted market price for the custom-built equipment, and Debtor has not previously purchased similar equipment. Debtor recognizes the debt based on the present value of the cash flows using the market interest rate.

Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Equipment ¹	44,846	
Note payable – Discount ¹	5,154	
Note payable		50,000
<i>To recognize purchase of equipment for note payable.</i>		
Note:		
<p>1. The present value of the cash flows from the debt instrument is based on \$56,000 in future cash flows, the debt's three-year term, and an 8% market rate. The total future cash flows are based on a \$50,000 par value with a 4% stated interest rate, resulting in \$2,000 cash payments for interest each year over a three-year period (\$50,000 + \$6,000 in total interest).</p> <p>Present value is calculated for each annual cash flow:</p> <p style="padding-left: 20px;">Year 1: $\\$2,000 \times 1 \div (1+.08)^1 = \\$1,852$</p> <p style="padding-left: 20px;">Year 2: $\\$2,000 \times 1 \div (1 + .08)^2 = \\$1,715$</p> <p style="padding-left: 20px;">Year 3: $\\$52,000 \times 1 \div (1 + .08)^3 = \\$41,279$</p> <p style="padding-left: 20px;">Present value of total cash flows: \$44,846</p> <p>The discount on the note payable is the difference between the par value of the note and the fair value of the note (\$50,000 - \$44,846 = \$5,154).</p>		

**Question 3.3.60****How is a right or privilege measured when it's attached to debt in exchange for cash?**

Interpretive response: When a debtor issues debt for cash plus a stated or unstated right or privilege (e.g. an agreement to enter into a future transaction), the amount assigned to the right or privilege is the difference between: [835-30-25-6]

- the fair value of the debt (using the market interest rate); and
- the cash exchanged.

Further, any difference between fair value and the par value of the debt is recorded as a premium or discount.

**Example 3.3.40****Debt issued for cash plus a right or privilege**

On December 31, Year 4, Debtor issues a five year, 7%, \$100,000 par value bond to Creditor. Proceeds include \$110,000 cash plus consulting services to be performed by Creditor over the course of the bond's term.

On December 31, Year 4, the fair value of the bond is \$106,942.

Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash ¹	110,000	
Prepaid consulting services ²	3,058	
Bond payable ³		100,000
Bond payable – Premium ⁴		13,058
<i>To recognize issuance of bond.</i>		

Notes:

1. To record \$110,000 cash proceeds received upon issuance of the bond.
2. The difference between the fair value of the bond (\$106,942) and the cash proceeds received (\$110,000) is allocated to the value of the consulting services to be received. The consulting services are recorded as prepaid and will be recognized as an expense as the services are provided by Creditor.
3. The bond payable is recorded at its par value of \$100,000.
4. The difference between the total proceeds received and par value of the bond is recorded as a debt premium.

3.4 Debt issuance costs

3.4.10 Overview

A debtor typically incurs a number of costs as part of its financing transaction. Such issuance costs can generally be categorized as:

- fees received from or paid to creditors;
- third-party costs; or
- other costs.

Direct incremental costs paid to third parties and directly attributable to the borrowing transaction are referred to as debt issuance costs and are capitalized to the carrying amount of the debt. Such costs are presented on the balance sheet as a direct deduction from that debt liability, consistent with the presentation of a debt discount.



Question 3.4.10

What are common examples of each type of cost incurred by a debtor?

Interpretive response: The following are common examples of issuance costs.

<p>Fees received from or paid to creditors as part of the issuance of debt</p>	<ul style="list-style-type: none"> — Original issue discounts arise when the debtor offers debt with a principal in excess of the initial cash received – i.e. at a discount. For example, Debtor issues debt with a principal of \$1,000 for cash proceeds of \$995. — Creditor fees paid by the debtor arise when the debtor agrees to pay all or a portion of fees incurred by the creditor in the transaction. For example, Debtor issues notes payable to Creditor and Debtor agrees to pay the first \$100,000 of legal fees incurred by Creditor.
<p>Third-party costs</p>	<ul style="list-style-type: none"> — Accounting or legal fees of the debtor. — Fees paid to investment bankers, underwriters or agents – e.g. fees paid to an agent bank in a loan syndicate for its role in arranging a syndicate. — Document preparation or printing costs. — Fees paid to rating agencies.
<p>Other costs</p>	<ul style="list-style-type: none"> — Compensation or other costs associated with the debtor’s treasury department. — Compensation or other expenses directly incurred by employees of the debtor in connection with the transaction. — Bonuses paid to employees for raising funds. — Covenant waiver fees arise when the debtor, who fails to meet a covenant requirement under the terms of the debt arrangement, pays a fee to the creditor to waive the covenant requirement for a specific period.

**Question 3.4.20****How are the various costs incurred by a debtor accounted for?**

Interpretive response: How the costs incurred by a debtor in connection with a debt financing transaction are accounted for depends on the nature of the costs incurred, as follows.

Fees received from or paid to creditors as part of the issuance of debt	<p>Accounted for in the same manner as a premium or discount on the debt.</p> <p>A debt premium or discount is reported as a direct addition to or reduction from the par value of the associated debt liability. They are considered valuation accounts because they are separate items that increase or decrease the net carrying amount of a liability and are included in the net carrying amount of the related debt in the financial statements. [835-30-45-1A]</p>
Third-party costs	<p>Deferred and amortized over the term of the debt as a component of interest expense in the same manner as fees paid to the creditor.</p> <p>These costs are presented on the balance sheet as a direct deduction from the par value of the associated debt liability, consistent with the presentation of a debt discount. [835-30-45-1A]</p>
Other costs	<p>Other costs that a debtor may incur in connection with debt financing include internal compensation costs and covenant waiver fees.</p> <ul style="list-style-type: none"> — Internal costs related to a debt issuance are expensed as incurred. — Treatment of covenant waiver fees paid to the creditor depends on whether modification or extinguishment accounting is applied. See Questions 4.5.70 and 4.6.40.

A debtor generally amortizes premiums, discounts and debt issuance costs over the stated term of the debt using the effective interest method, with the amortization classified as a component of interest expense (see section 3.4.30). [835-30-55-2]

Debt issuance costs are expensed as incurred if they relate to debt for which a fair value option election has been made (see section 3.3.10).

For guidance on classifying payments for debt issuance costs in the statement of cash flows, see section 12 of KPMG Handbook, [Statement of cash flows](#).



Question 3.4.30

How are debt issuance costs accounted for if they are incurred before an associated debt liability is recorded?

Interpretive response: Debt issuance costs may be incurred before an associated debt liability is recorded in the financial statements – before the proceeds are received on a debt liability or in association with an undrawn line of credit.

The FASB acknowledged that generally in practice entities defer issuance costs and apply them against the proceeds when they are received. For example, issuance costs associated with equity instruments are generally deferred and charged against the gross proceeds of the offering. [\[ASU 2015-03.BC4, 340-10-S99-1\]](#)



Question 3.4.40

How are debt issuance costs accounted for when they relate to debt issued with detachable stock purchase warrants?

Interpretive response: There is no specific guidance that addresses allocating debt issuance costs between the debt and related detachable stock purchase warrants.

If evidence suggests that individual costs were incurred specifically for the debt instrument or the warrants, we believe the issuer should allocate the specific costs to the respective components.

Otherwise, the following methods are generally accepted:

- allocating an amount to the debt component that results in an effective interest rate on the debt comparable to other recent debt issues of similar risk and maturity – with the residual being allocated to the warrant component;
- allocating an amount to the warrant component comparable to costs for issuing stand-alone warrants – with the residual being allocated to the debt component; or
- allocating costs between the debt and warrant components in proportion to the allocation of the issuance proceeds (see section 3.3.20).

Issuance costs allocated to a component are reported as a reduction of the related issuance proceeds (see Questions 3.4.20 and 5.10.30). However, if either or both instruments are subsequently measured at fair value (e.g. under Topic 825 for the debt instrument or under Subtopic 815-40 for the warrant instrument), we believe any issuance costs allocated to that instrument(s) should be expensed.



Question 3.4.50

How does a debtor account for fees incurred in a bridge financing?

Background: Debtor enters into a purchase agreement to acquire Target. Debtor also enters into an arrangement with Investment Bank to provide Debtor with interim financing to fund the acquisition until permanent financing can be arranged at a later date through a debt offering. Investment Bank will be the underwriter.

This type of interim financing arrangement with Investment Bank is referred to as bridge financing. Debtor pays Investment Bank fees (which are separate from any underwriter fees) to enter into the bridge-financing arrangement.

Interpretive response: SEC registrants are required to recognize fees incurred as part of a bridge financing arrangement as interest expense during the estimated interim period preceding the placement of the permanent financing.

Therefore, the fees are deferred and amortized by the effective interest method over the estimated bridge financing period. Any unamortized amount is charged to interest expense if the bridge loan is repaid in cash or replaced with long-term financing from different third-party lenders before the estimated bridge financing period expires. [\[340-10-S99-2\]](#)

However, if the bridge financing is modified or exchanged with the existing lenders, we believe the debt restructuring is evaluated based on the guidance in Subtopic 470-50 or Subtopic 470-60, as applicable, and the deferred fees should be accounted for based on the application of that guidance; see chapter 4.



Question 3.4.60

How does an SEC registrant account for fees incurred in a shelf registration?

Background: If an SEC registrant incurs direct, incremental fees in connection with an SEC filing for a stock issue it plans to sell under a shelf registration, the costs are deferred as a prepaid expense until the securities are taken off the shelf and sold.

At that time, a portion of the costs attributable to the securities sold is charged against paid-in capital. If at any point the registrant determines that it will not issue additional equity shares under the shelf registration, it writes off the remaining capitalized costs as an expense.

Costs incurred after the initial shelf registration to keep the filing alive are charged to expense as incurred. If the filing is withdrawn, the related deferred costs are charged to expense. [\[340-10-S99-1\]](#)

Interpretive response: Similar to fees incurred in connection with a stock offering, we believe that if a registrant incurs costs associated with a debt shelf registration statement, any prepaid costs should be deferred and later allocated to the debt instruments when they are issued under the shelf registration. Upon

issuance of the debt instruments, the registrant should follow the guidance on accounting for debt issuance costs discussed in this section.

3.4.20 Fees incurred related to lines of credit and other similar debt arrangements

A line-of-credit (or revolving-debt arrangement) is an agreement that provides the debtor with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then reborrow under the same contract. Line-of-credit and revolving-debt arrangements may include both amounts drawn by the debtor (a debt instrument) and a commitment by the creditor to make additional amounts available to the debtor under predefined terms (a loan commitment). [470-50 Glossary]

Guidance in Subtopic 835-30 addresses when to present premiums, discounts and debt issuance costs as direct reductions (or additions) to the par value of a note (see Question 3.4.20). However, this guidance was written in the context of term 'debt' and therefore does not address debt issuance costs related to line-of-credit arrangements. [835-30-45]



Question 3.4.70

How are debt issuance costs related to a line-of-credit arrangement accounted for?

Interpretive response: The SEC staff has stated that it would not object to a debtor deferring and presenting debt issuance costs as an asset and subsequently amortizing these deferred costs ratably over the term of a line-of-credit arrangement; this is regardless of whether there are outstanding borrowings under that line-of-credit arrangement. [EITF observer comments 06/15, 835-30-S35-1, S45-1]

Presenting debt issuance costs as an asset is not mandatory. A debtor can elect to apply another presentation approach if it is rational, and consistently applied.

We believe that fees directly paid to the creditor and third-party fees for the origination of line-of-credit arrangements should be considered debt issuance costs. Therefore, all such debt issuance costs may be presented by the debtor as an asset, instead of as a direct deduction from the carrying amount of any debt liability and amortized ratably over the term of the line-of-credit arrangement; this is regardless of whether there is a balance outstanding.

Other periodic fees incurred relating to a line-of-credit arrangement are generally expensed as incurred.



Example 3.4.10

Costs related to line-of-credit arrangement

On January 1, Year 1, Debtor enters into a \$50 million line-of-credit arrangement with an interest rate of 5% from Bank that can be drawn any time over the next three years. To secure this credit facility, Debtor pays Bank \$100,000 in lender fees, and incurs \$50,000 in third-party costs, on January 1, Year 1.

Debtor elects to present the lender fees and the third-party costs as an asset, regardless of whether the line is drawn. The asset is amortized into interest expense over the life of the line-of-credit arrangement.

Each month, Debtor recognizes \$4,167 ($\$150,000 / 3 \text{ years} / 12 \text{ months}$) of expense related to the line-of-credit arrangement and presents it as interest expense in the income statement.

3.4.30 Amortization of debt issuance costs



Excerpt from ASC 835-30

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

45-1A The **discount** or **premium** resulting from the determination of present value in cash or noncash transactions is not an asset or liability separable from the note that gives rise to it. Therefore, the discount or premium shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Similarly, debt issuance costs related to a note shall be reported in the balance sheet as a direct deduction from the face amount of that note. The discount, premium, or debt issuance costs shall not be classified as a deferred charge or deferred credit.

45-2 The description of the note shall include the effective interest rate. The face amount also shall be disclosed in the financial statements or in the notes to the statements.

45-3 Amortization of discount or premium shall be reported as interest expense in the case of liabilities or as interest income in the case of assets. Amortization of debt issuance costs also shall be reported as interest expense.

A debtor generally amortizes premiums, discounts and debt issuance costs using the effective interest method (see Question 3.4.20). This method's objective is to attribute a constant cost of borrowing from inception until the estimated date at which the funds must be returned. This estimated date may be different from the debt's stated maturity date if the debt contains a call or put option (see Question 3.4.80).




Question 3.4.80

What factors are considered when determining the amortization period for premiums, discounts or debt issuance costs?

Interpretive response: A debtor considers the following factors when determining the amortization period for premiums, discounts and debt issuance costs.

Factor	Considerations
<p>Creditor can require payment before stated maturity (puttable debt)</p>	<p>If a creditor has the ability to require payment before the stated maturity date (e.g. through a non-contingent put right), the debtor generally amortizes the discount and debt issuance costs from the date the debt is issued to the earliest date at which the creditor can demand payment.</p> <p>This is consistent with:</p> <ul style="list-style-type: none"> — paragraph 470-10-45-10, which states that a note with a demand feature is a current obligation; and — the general notion that current obligations should be stated at or near the amount of cash that could be required to satisfy them. <p>However, if the debt is issued at a significant premium such that exercising the put right at par value would not be economical to the creditor, we believe the debtor should generally amortize the premium over the stated term of the debt.</p> <p>Further, if the debt is puttable at its accreted value by the creditor, we believe the entity should accrete the discount (or amortize a premium) over the contractual term of the debt. However, an entity could elect to accrete debt issuance costs over either the contractual term or the date the debt first becomes puttable (and consistently apply the chosen policy).</p>
<p>Debtor can repay debt before stated maturity (prepayable or 'callable' debt)</p>	<p>If a debtor has the intent and ability to repay the debt before the stated maturity date (e.g. through a non-contingent call right), we believe it may make a policy election to amortize the premium, discount and debt issuance costs over either the stated term of the debt or over the estimated (shorter) life of the debt. We believe that amortization over the shorter estimated life is acceptable based on an analogy to the guidance for increasing-rate debt (below).</p> <p>However, if the creditor can require payment before the stated maturity date, the amortization period for callable debt may not extend beyond the earliest date at which the creditor can demand payment (as explained above).</p>
<p>Anticipated future refinancing by the debtor</p>	<p>A debtor should not consider the term of an anticipated refinancing of the current debt when determining the amortization period; this is because the creditor can demand repayment on maturity of the current debt.</p> <p>For example, Debtor issues debt with a one-year term but intends to refinance the debt at the end of that term with a</p>

Factor	Considerations
	similar debt instrument having a four-year term. In this example, Debtor should amortize the premium or discount and debt issuance costs over one year.
Increasing-rate or term-extending debt	The debtor amortizes the premium, discount and debt issuance costs on increasing rate or term extending debt over the estimated term of the debt.

 **Question 3.4.90**
When is it appropriate to change or accelerate the amortization of premiums, discounts or debt issuance costs?

Interpretive response: A debtor generally should not change the amortization period after the issuance of debt. Similarly, it should not write off the unamortized premium, discount or debt issuance costs unless one of the following occurs.

Scenario	Considerations
Debt is extinguished or partially extinguished	<p>Unamortized premiums, discounts and debt issuance costs are part of the net carrying amount of debt. A debtor should not write them off until it has extinguished or partially extinguished the debt. On a full or partial extinguishment, the debtor should include the balance of unamortized premium, discount and debt issuance costs (or an allocable portion in the case of a partial extinguishment) in the extinguishment gain or loss. [470-50-40-2, 40-17 – 18]</p> <p>See section 4.5 for examples of accounting for unamortized premiums, discounts and debt issuance costs in a full or partial extinguishment.</p>
Debt is exchanged or modified	<p>When a debtor exchanges or modifies the debt issued, the significance of the modification or exchange is the basis for the accounting for the unamortized premium, discount and debt issuance costs.</p> <ul style="list-style-type: none"> — If the original and new instruments are ‘substantially different’ (as defined in Subtopic 470-50), the debtor records the new debt at fair value and includes the unamortized premium or discount and debt issuance costs related to the old debt in the extinguishment gain or loss. [470-50-40-13, 40-17 – 40-18] — If they are not ‘substantially different’, a new effective interest rate is determined that subsumes the unamortized premium or discount and debt issuance costs related to the old debt. [470-50-40-14, 40-17 – 40-18] <p>See section 4.4 for additional guidance on modifications and extinguishments.</p>

Scenario	Considerations
<p>Creditor obtains the ability to demand immediate payment</p>	<p>If a debtor reclassifies debt on its balance sheet as a current obligation as a result of:</p> <ul style="list-style-type: none"> — a covenant violation at a reporting date or a contingent put option becomes exercisable; — the creditor has the contractual right to demand payment; and — the creditor has stated its intention to call the loan and the debt instrument includes unamortized premiums, discounts or debt issuance costs, <p>then we believe the debtor should recognize the unamortized amounts from the date of notification to the date the debt is due to the creditor.</p> <p>In contrast, if the debtor violates a covenant but the creditor does not demand payment, the debtor reassesses whether the amortization period for any unamortized premiums, discounts or debt issuance costs remains appropriate.</p> <p>See section 3.6 for additional guidance on the classification of debt.</p>
<p>Conversion option is exercised in a convertible debt instrument (other than induced conversions)</p>	<p>The net carrying amount of convertible debt includes unamortized premiums, discounts and debt issuance costs.</p> <p>If the debtor initially allocated no proceeds to the conversion feature, it reclassifies the net carrying amount of convertible debt (including unamortized premiums, discounts and debt issuance costs) as equity on conversion by the holder. In this case, the debtor generally does not record a gain or loss on conversion. [470-20-40-4]</p> <p>For additional guidance on amortization of discounts and premiums on convertible instruments, see section 10.7.</p>
<p>Payment of the debt is subsequently required or expected to be accelerated</p>	<p>A debtor may need to adjust the estimated amortization period for any unamortized premiums, discounts and debt issuance costs of a debt obligation if repayment of the debt is accelerated because:</p> <ul style="list-style-type: none"> — the debtor enters into a transaction wherein the terms of the debt agreement require repayment of the debt – e.g. repayment is required in the event of an asset sale; or — a contingent put option is no longer contingent – e.g. the creditor has an ability to put the debt back to the debtor if the debtor’s credit rating decreases, and that decrease has occurred (giving the creditor the ability to now require repayment). See Question 3.4.100. <p>In these circumstances, it may be appropriate to amortize the unamortized premiums, discounts and debt issuance costs over the remaining period of time until the debt is expected to be repaid – e.g. amortize the remaining unamortized amounts from the current period to the new expected repayment date.</p>



Question 3.4.100

Over what period are debt premiums, discounts and debt issuance costs amortized when the debt is contingently puttable by the creditor?

Background: Debtor borrows \$100,000 with a fixed maturity date in five years. The agreement includes a provision that allows the creditor to put the debt back to the debtor at \$100,000 if certain conditions (the contingent provisions) occur. The debtor incurs \$5,000 of debt issuance costs related to this borrowing.

Interpretive response: In this background scenario, the debt is contingently puttable by the creditor. While there is diversity in practice, generally we believe a debtor should amortize premiums, discounts and debt issuance costs over the contractual life of the debt (five years in this instance) unless the contingency has been met. Once the contingency is met, the debt instrument becomes due on demand and any unamortized premiums, discounts and debt issuance costs should be recognized from the current period through the new expected repayment date. For example, if the put option allows the creditor to immediately put the debt when the contingency is met, any remaining unamortized premiums, discounts and debt issuance costs should be expensed immediately.



Question 3.4.110

Over what period are debt premiums, discounts and debt issuance costs amortized for debt with a 'springing maturity' feature?

Background: Debt with a 'springing maturity' feature is debt with an initial maturity date that is automatically extended if certain contingencies are met on or before the initial maturity date. Lenders may offer these features as better credit protection when, for example, the borrower's obligation under other debt outstanding is reduced. Similarly, these features may provide borrowers with flexibility to manage their liquidity and cash flows on a long-term basis.

Interpretive response: We understand there are two views in practice on the appropriate amortization period, which are explained in the following table. We believe either view is acceptable as an accounting policy election that is consistently applied.

View A: The amortization period is based solely on the <i>current active maturity date</i>	View B: The amortization period is based on the <i>estimated term of the debt</i>
The current active maturity date is the date that the debt will mature, assuming the contingencies are <i>not</i> met. The amortization period is evaluated each balance sheet date based on the current active maturity date at the time of evaluation.	Under this view, the amortization period is determined based on the estimated term of the debt on each balance sheet date based on an analysis of whether the contingencies will be met and the springing maturity feature will be activated. When estimating the term of the debt, a debtor should consider its

View A: The amortization period is based solely on the <i>current active</i> maturity date	View B: The amortization period is based on the <i>estimated</i> term of the debt
	ability and intent in meeting the contingencies to activate the springing maturity feature and its plans to otherwise call or prepay the debt before its springing maturity date.

Question 3.4.90 addresses when it is appropriate to change or accelerate the amortization of premiums, discounts or debt issuance costs. Question 3.5.10 addresses how changes in the estimated term are accounted for.

See also Question 3.6.210 about balance sheet classification of debt with a springing maturity feature.



Example 3.4.20

Amortization period for 'springing maturity' debt

Debtor borrows \$10 million from Creditor XYZ on January 1, Year 1 and incurs \$500,000 of debt issuance costs related to this borrowing. In addition, Debtor has the following debt outstanding:

- Term Debt A: matures on March 31, Year 4; and
- Term Debt B: matures on March 31, Year 5.

The debt with Creditor XYZ includes what is referred to as a 'springing maturity' feature whereby the debt is scheduled to mature in advance of the existing debt unless certain conditions are met. Under that feature, the debt with Creditor XYZ matures on:

- **December 31, Year 3 (the 1st springing maturity date)**. However, it does not mature on that date if – on that date – Debtor has repaid Term Debt A.
- **December 31, Year 4 (the 2nd springing maturity date)**. However, it does not mature on that date if – on that date – Debtor has repaid Term Debt B.
- **December 31, Year 5 (the final maturity date)**.

As discussed in Question 3.4.110, we believe there are two acceptable accounting policies when determining the amortization period.

This Example assumes Creditor concludes that no embedded features require bifurcation and separate accounting. Note that a term-extending option represents a loan origination commitment and a scope exception from derivative accounting applies to the holder – i.e. the potential borrower – of a loan commitment. Section 2.11.20 of KPMG Handbook, [Derivatives and hedging](#), addresses the loan commitment scope exception as it applies to holders of a loan origination commitment.

Scenario 1: Amortization period based on current active maturity date

When the debt is issued, its current active maturity date is December 31, Year 3. Therefore, the initial amortization period is three years. At each balance sheet

date, Debtor assesses whether the contingencies were met, resulting in a change in the current active maturity date (and related amortization period).

For example, if Debtor repays Term Debt A on June 30, Year 1, the current active maturity date is extended to December 31, Year 4. Debtor accounts for the resulting change in the amortization period prospectively.


Scenario 2: Amortization period based on estimated term of debt

When the debt is issued, Debtor considers its plans to service all of the debt, including its ability and intent to call and prepay any of the debt before maturity. These considerations include the likelihood of the springing maturity feature in the debt with Creditor XYZ being activated and the debt being extended through December 31, Year 4 or December 31, Year 5. Debtor continually updates its estimate of the term and accounts for any changes prospectively.

3.5 Subsequent accounting and measurement

3.5.10 Accounting for outstanding debt

Generally, unless a debtor is required or elects to subsequently measure debt at fair value, it subsequently measures the debt at amortized cost. This means the value allocated to the debt instrument at initial recognition is classified as a liability and accreted or amortized to par value.

 **Example 3.5.10**
Subsequent accounting for term loan and related debt issuance costs

On January 1, Year 4, Debtor enters into a term-loan arrangement with Bank with the following provisions:

- the principal amount of the debt is \$1 million;
- the debt matures on December 31, Year 13;
- the stated annual interest rate on the debt is 5%;
- Debtor pays \$30,000 in origination fees to Bank; and
- Debtor incurs \$20,000 in legal fees to a third-party law firm.

Debtor records the following journal entry on January 1, Year 4.

	<i>Debit</i>	<i>Credit</i>
Cash ¹	1,000,000	
Debt – unamortized debt issuance costs ²	20,000	
Debt – unamortized discount ³	30,000	
Debt – loan payable ¹		1,000,000
Cash (fees and debt issuance costs)		50,000
<i>To recognize issuance of debt and related costs.</i>		

Notes:

1. To record the debt issuance and cash received.
2. Third-party legal fees are recorded as debt issuance costs, as a reduction of the net carrying amount of the debt.
3. Fee paid to creditors (i.e. origination fees) are recorded as debt discounts and reduce the net carrying amount of the related debt.

The debt discount and debt issuance costs are amortized into interest expense each period under the effective interest method. The effective interest rate in this example is calculated as 5.67%.

Debtor records the following journal entry on December 31, Year 4.

	<i>Debit</i>	<i>Credit</i>
Interest expense ¹	53,850	
Cash ²		50,000
Debt – unamortized debt issuance costs ³		1,540
Debt – unamortized debt discount ³		2,310
<i>To recognize interest expense.</i>		

Notes:

1. Total interest expense recorded at the effective interest rate (effective interest rate × current net carrying amount of \$950,000).
2. Cash paid for interest at the stated rate of 5% per year (\$1 million × 5%).
3. The difference between total interest expense at the effective interest rate of \$53,850 and the cash paid at the stated rate of \$50,000 represents the amortization into interest of the debt discount and debt issuance costs.

Each year Debtor will record the annual interest cost consistent with the journal entry above. However, the amounts will increase each year because the net carrying amount of debt will increase as the debt discount and debt issuance costs are amortized. Over the 10-year term of the loan, the debt discount and debt issuance costs will be amortized down to zero, accreting the net carrying amount of the loan to the principal balance of \$1 million at maturity (December 31, Year 13).

Example 3.5.20

Subsequent accounting for term loan with PIK interest

On January 1, Year 1, Debtor enters into a term-loan arrangement with Bank with the following provisions:

- the initial principal of the debt is \$10 million;
- the debt matures on December 31, Year 10;
- the stated interest rate on the debt is 10%, with interest required to be paid in kind; and

- Debtor pays \$400,000 in legal and other third-party costs upon issuance of the debt.

Debtor records the following journal entry on January 1, Year 1.

	<i>Debit</i>	<i>Credit</i>
Cash ¹	10,000,000	
Debt – unamortized debt issuance costs ²	400,000	
Debt – loan payable ¹		10,000,000
Cash (debt issuance costs)		400,000
<i>To recognize issuance of debt and related costs.</i>		
Notes:		
1. To record the debt issuance and cash received.		
2. Third-party fees are recorded as debt issuance costs, as a reduction of the net carrying amount of the debt.		

Because interest is required to be PIK (instead of cash interest payments each period), Debtor will pay interest through additional principal. Debtor records interest expense based on the stated rate of interest of 10%. Further, the debt issuance costs are accreted into the carrying amount of the debt and interest expense each period under the effective interest method. The effective interest rate in this example is calculated as 10.45% (rounded).

Debtor records the following journal entry on December 31, Year 1 (rounded).

	<i>Debit</i>	<i>Credit</i>
Interest expense ¹	1,003,200	
Debt – principal amount due ²		1,000,000
Debt – unamortized debt issuance costs ³		3,200
<i>To recognize additional principal due from PIK interest.</i>		
Notes:		
1. Current net carrying amount of (\$9.6 million) × effective interest rate (10.45%).		
2. Principal (\$10 million) × stated rate of interest of (10%).		
3. Total interest expense (\$1,003,200) – PIK interest (\$1 million).		

Debtor records the following journal entry on December 31, Year 2 (rounded).

	<i>Debit</i>	<i>Credit</i>
Interest expense ¹	1,108,000	
Debt – principal amount due ²		1,100,000
Debt – unamortized debt issuance costs ³		8,00
<i>To recognize additional principal due from PIK interest.</i>		

Notes:

1. Current net carrying amount (\$10.6 million) × effective interest rate (10.45%).
2. Principal (\$11 million) × stated rate of interest (10%).
3. Total interest expense (\$1,108,000) – PIK interest (\$1.1 million).

Each year Debtor will record the annual interest cost consistent with the entries above. The interest cost will increase each year because the net carrying amount of debt will increase as the debt issuance costs are accreted and additional PIK interest is recorded. Over the 10-year term of the loan, the debt issuance costs will be amortized down to zero. Further, total PIK interest will accumulate to approximately \$15,937,000, accreting the net carrying amount of the loan to a total principal balance of approximately \$25,937,000 at maturity (December 31, Year 10).



Question 3.5.10

How are changes in the estimated term of a debt instrument accounted for?

Interpretive response: There is no specific guidance on updating the estimated life of a debt instrument. In our experience, some debtors make an accounting policy election at the inception of a debt instrument to continually update their estimates of the debt instrument's life and account for any changes prospectively.

We believe such a policy – which should be applied consistently to all debt instruments – requires a debtor to:

- continuously re-estimate the life of the instruments; and
- record interest expense and accrete/amortize related discounts, premiums and debt issuance costs based on its reassessed best estimate of the life of the instrument.

When estimating the life of the debt, a debtor should consider its plans to service the debt, including its ability and intent to call the debt before maturity or likelihood of electing term-extending options.

3.6 Presentation

3.6.10 Presentation – debt classification framework

A debtor that presents a classified balance sheet classifies debt (or a portion thereof) as either a current or a noncurrent liability. [210-10-45-6 – 45-9]

- **Current liability.** A debt obligation is classified as current if (by its terms) it is due or will be due on demand within one year (or an operating cycle, if longer) from the reporting date. An operating cycle is the time required for a business to produce, sell and receive cash from customers in exchange for goods or services.

- **Noncurrent liability.** A debt obligation due more than one year (or operating cycle, if longer) from the reporting date is classified as noncurrent.

The following are common debt provisions and circumstances that can affect the classification of debt or a revolving credit agreement.

Terms and conditions	Reference
Subjective acceleration clause, or other subjective provision	section 3.6.10
Short-term obligation expected to be refinanced on a long-term basis	section 3.6.20
Requirement for the debtor to maintain a lock-box arrangement with the creditor	section 3.6.30
Provision that allows the creditor to demand payment before maturity	section 3.6.40
Long-term obligation that is or will be callable by a creditor because the debtor has violated a provision of the debt arrangement	section 3.6.40
Terms of some convertible debt instruments with cash conversion features, where the holder is permitted to convert the debt instrument currently or within one year of the reporting date; this is regardless of whether the conversion feature is out-of-the-money.	section 10.9.20

The presentation requirements are discussed in this section. See section 3.8 for a more complete explanation of the disclosure requirements.

Note: Throughout this section, the use of the term ‘one year’ includes an ‘operating cycle, if longer’. Similarly, the term ‘the date financial statements are issued’, also refers to ‘the date available to be issued’ for non-SEC filers or conduit bond obligors.

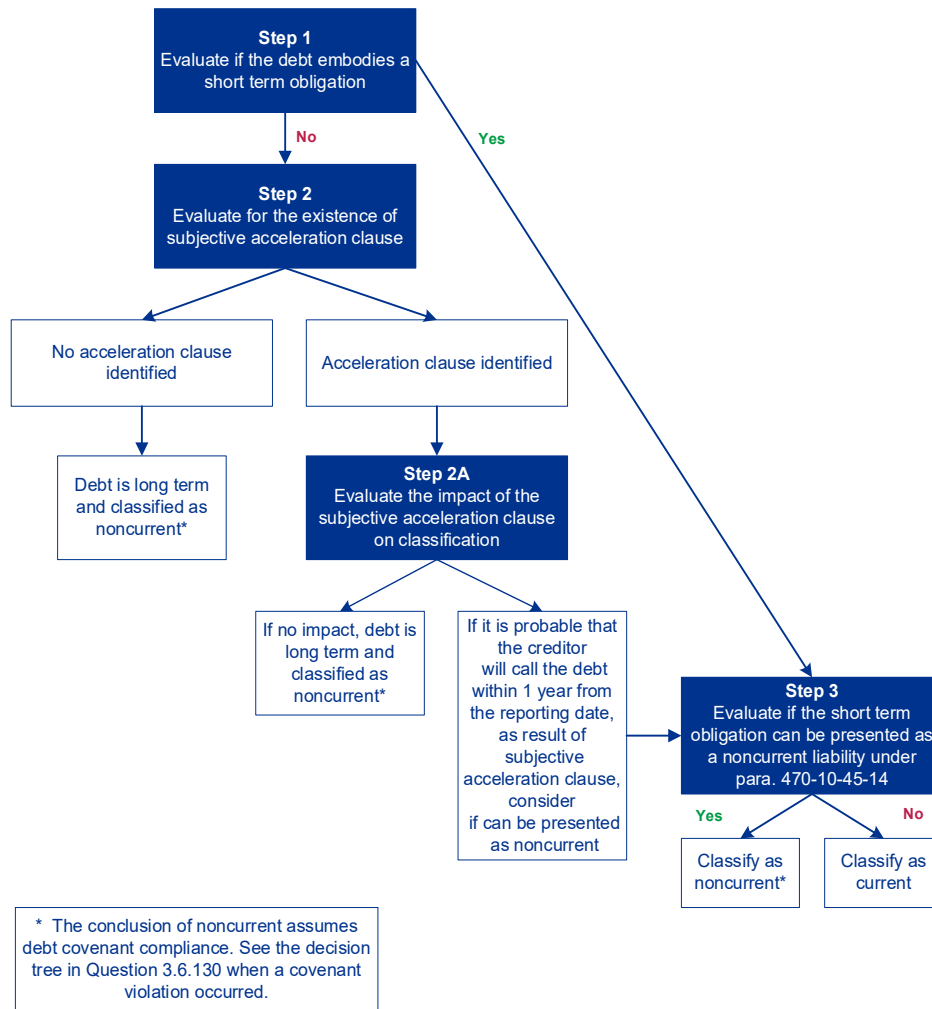


Question 3.6.10

What is the framework for classifying a debt obligation as a current or noncurrent liability?

Interpretive response: Classification as current or noncurrent is grounded in the expectation of when and how the debtor will settle the obligation; therefore, determining whether a debt obligation should be classified as a current or noncurrent liability can be challenging. It requires an understanding of the terms of the arrangement, analysis of the relevant accounting literature and evaluation of the effects of the individual provisions in the debt agreement on balance sheet classification. Noncompliance with provisions of a debt or revolving credit agreement also can affect the classification of the related obligation.

We believe the general debt classification framework can be described using this three-step process.



Step 1 in the debt classification framework is to evaluate whether a debt embodies a short-term obligation.

- If it does, Steps 2 and 2A in the framework are not relevant and the debt is evaluated under Step 3 to determine if it should be classified as noncurrent even though it is a short-term obligation.
- If the debt does not embody a short-term obligation, it is evaluated under Step 2 next (and then potentially under Step 2A and Step 3) to determine its classification.

Step 1: Evaluate whether debt embodies a short-term obligation



Question 3.6.20

What does a debtor consider when evaluating whether a debt embodies a short-term obligation?

Interpretive response: A debtor considers several factors in this evaluation, including (but not limited to) the following.

Are the contractual repayment dates less than one year after the reporting date? If less than one year, the debt (or a portion thereof) is a short-term obligation, even if payment is not expected within that period. However, if the debtor intends to refinance the short-term obligation on a long-term basis, additional consideration is given to the debtor's ability to consummate the refinancing (Step 3).

Is the debt due on demand or will it become due on demand within one year of the reporting date? This includes a revolving agreement with a required lock-box arrangement described in section 3.6.30.

Are there covenant violations that can accelerate the maturity of the debt or provide the creditor with the ability to demand repayment (see section 3.6.40)?

If the debtor has the right to prepay a long-term debt obligation (e.g. through an issuer call option), does it intend to repay the debt using current assets (e.g. cash) or by incurring a current liability (e.g. the drawdown of a short-term line of credit)? In these instances, it may be appropriate to conclude that the debt embodies a short-term obligation even if it would otherwise be considered a long-term obligation (see Question 3.6.30).



Question 3.6.30

How is a debtor's right to prepay the debt before maturity considered in its balance sheet classification?

Interpretive response: If a debtor has the right to repay long-term debt before the stated maturity date, it classifies the outstanding borrowings under the debt (or revolving credit agreement) based on the definition of a current liability.

We believe relevant factors are:

- the debtor's intent to repay the debt within one year from the reporting date; and
- the classification of the assets expected to be used to repay the obligation.

When certain assets are reasonably expected to be used to repay an obligation, the classification of both the assets expected to be used and the obligation are affected. The classification of the obligation is based on the classification of the

assets that will be reasonably expected to be used to repay the obligation. [210-10-45-4]

However, there are differing views on the classification of assets that are specifically set aside to satisfy an obligation. We believe applying the guidance in Topic 210 is an accounting policy election of the debtor and either of the following views are acceptable.

View A	View B
<p>If the debtor expects to repay the debt using current assets (e.g. cash) or by creating a current liability (e.g. the drawdown of a short-term line of credit), it is appropriate to classify the debt as a current liability even if the contractual maturity of the debt extends beyond one year.</p>	<p>If the debtor expects to repay the debt using specified assets (e.g. cash) existing at the reporting date, the assets may be considered restricted for use; in meeting this condition, the assets do not need to be set aside in a special account. Therefore, it is appropriate to classify those specified assets as noncurrent and continue to classify the debt as a noncurrent liability.</p>

A debtor should disclose its policy and the impact on the presentation of any related assets.

The debtor should classify the debt as a noncurrent liability if it does not intend to repay the debt within one year from the reporting date and no other circumstances indicate that it should classify the debt as a current liability.

Step 2: Evaluate debt for existence of a subjective acceleration clause



Excerpt from ASC 470-10

20 Glossary

Subjective Acceleration Clause

A subjective acceleration clause is a provision in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, if the debtor fails to maintain satisfactory operations or if a material adverse change occurs).

Step 2 of the debt classification framework (see Question 3.6.10) is to evaluate whether the debt contains a subjective acceleration clause. This step is reached only if the debt does not embody a short-term obligation (see Step 1 above).

A debt that does not embody a short-term obligation is analyzed as follows.

- If it does not contain a subjective acceleration clause, classify the debt as noncurrent.
- If it contains a subjective acceleration clause, move to Step 2A (below) to assess the probability that the creditor will accelerate the due date of the

debt by exercising the subjective acceleration clause within one year of the reporting date.



Question 3.6.40

What type of provisions are considered subjective acceleration clauses?

Interpretive response: A subjective acceleration clause is a provision in a debt agreement that allows the creditor (not the debtor) to accelerate the repayment terms under conditions that are not objectively determinable based on the stated terms in the agreement. Material adverse change clauses are typical subjective acceleration clauses. [470-10 Glossary]

For example, the debt contains a subjective acceleration clause when the creditor is allowed to demand immediate payment on the debt should the debtor 'not maintain satisfactory operating results' or 'experience recurring losses' or 'experience financial difficulty' based on the creditor's own assessment.

In contrast, an acceleration clause based on an objective measure (e.g. a defined leverage ratio of the debtor) is not subject to the creditor's interpretation. A careful assessment of the terms of the debt agreement, including consultation with the debtor's legal counsel may be appropriate to understand the creditor's rights.

Step 2A: Evaluate the effect of a subjective acceleration clause on classification



Excerpt from ASC 470-10

> Subjective Acceleration Clauses and Debt Classification

45-2 In some situations, the circumstances (for example, recurring losses or liquidity problems) would indicate that long-term debt subject to a **subjective acceleration clause** should be classified as a current liability. Other situations would indicate only disclosure of the existence of such clauses. Neither reclassification nor disclosure would be required if the likelihood of the acceleration of the due date were remote, such as if the lender historically has not accelerated due dates of loans containing similar clauses and the financial condition of the borrower is strong and its prospects are bright.


> Implementation Guidance

• > Subjective Acceleration Clauses and Debt Classification

55-1 Under paragraph 470-10-45-2, the lender has already loaned money on a long-term basis. To continue long-term classification requires a judgment about the likelihood of acceleration of the due date. Paragraphs 470-10-45-13 through 45-20 cover circumstances in which the obligation is by its terms short-term. For such an obligation to be excluded from current liabilities, the lender must

advance new funds or refinance the short-term obligation on a long-term basis based on conditions existing on the date of the new loan or refinancing. Therefore, to classify an obligation as long-term, paragraphs 470-10-45-13 through 45-20 require a higher standard for a financing agreement that permits an entity to refinance a short-term obligation on a long-term basis than paragraph 470-10-50-2 requires for an existing long-term loan for which early repayment might be requested.

If a subjective acceleration clause has been identified, the next step in the debt classification framework is to evaluate the effect of a subjective acceleration clause on debt classification. [470-10-45-2]

 **Question 3.6.50**
How is the effect of a subjective acceleration clause on the debt’s classification determined?

Interpretive response: Step 2 requires a debtor to evaluate the likelihood that the creditor will accelerate the debt by invoking the subjective acceleration clause within one year from the reporting date. [470-10-45-2]

Scenario	Result
The likelihood of acceleration is remote	The debtor is not required to reclassify the debt to a current liability or to disclose the existence of the subjective acceleration clause. The likelihood of acceleration is remote when: <ul style="list-style-type: none"> — the creditor previously has not accelerated due dates of loans with similar clauses that it made to the debtor; — the debtor is not aware of any reason why the creditor would accelerate the due date; and — the financial condition and prospects of the debtor are otherwise supportive of the assessment.
The likelihood of acceleration is reasonably possible	We believe the debtor should evaluate the facts and circumstances to determine the proper classification of the debt and appropriate disclosures. The debtor should consider disclosing: <ul style="list-style-type: none"> — the nature and terms of the subjective acceleration clause, — the amount of the debt that would be due within one year of the reporting date; and — the date that the debt would be due if the creditor accelerates the due date.
The likelihood of acceleration is probable	If it is probable that the creditor will accelerate the due date, we believe the debtor should treat the debt as a short-term obligation. It should then evaluate the classification under Step 3 below. If the debtor determines under Step 3 that the debt is a current liability, it should disclose:

Scenario	Result
	<ul style="list-style-type: none"> — the nature and terms of the subjective acceleration clause; — the amount of the debt that may be due within one year of the reporting date; and — the date the debt would be due if the creditor accelerates the due date.

Step 3: Evaluate whether a short-term obligation should be classified as noncurrent



Excerpt from ASC 470-10

> Short-Term Obligations Expected to Be Refinanced

45-12A Some short-term obligations are expected to be refinanced on a long-term basis and, therefore, are not expected to require the use of working capital during the ensuing fiscal year. Examples include commercial paper, construction loans, and the currently maturing portion of long-term debt.

45-12B Refinancing a short-term obligation on a long-term basis means either replacing it with a long-term obligation or with equity securities or renewing, extending, or replacing it with short-term obligations for an uninterrupted period extending beyond one year (or the operating cycle, if applicable) from the date of an entity's balance sheet.

45-13 Short-term obligations arising from transactions in the normal course of business that are due in customary terms shall be classified as current liabilities. A short-term obligation shall be excluded from current liabilities only if the conditions in the following paragraph are met. Funds obtained on a long-term basis before the balance sheet date would be excluded from current assets if the obligation to be liquidated is excluded from current liabilities.

Step 3 of the debt classification framework (see Question 3.6.10) is to evaluate whether a short-term obligation should be classified as a noncurrent liability. This evaluation applies when a debt instrument (or a portion thereof): [\[470-10-45-14\]](#)

- embodies a short-term obligation, either due to the contractual repayment terms of the debt agreement or violations of debt agreement provisions (see Step 1); or
- should be treated as a short-term obligation based on the debtor's evaluation of a subjective acceleration clause (see Steps 2 and 2A).

Under Step 3, a debtor should not classify a short-term obligation as current if it has the intent and ability to refinance the obligation on a long-term basis. The debtor can demonstrate the intent and ability to refinance by either: [470-10-45-14](#)

- issuing a long-term obligation to replace the short-term obligation, or issuing equity securities; or
- entering into a financing arrangement that permits the debtor to refinance the short-term obligation on a long-term basis (see section 3.6.20).

3.6.20 Intent and ability to refinance on a long-term basis



Excerpt from ASC 470-10

> Intent and Ability to Refinance on a Long-Term Basis

45-14 A short-term obligation shall be excluded from current liabilities if the entity intends to refinance the obligation on a long-term basis (see paragraph 470-10-45-12B) and the intent to refinance the short-term obligation on a long-term basis is supported by an ability to consummate the refinancing demonstrated in either of the following ways:

- a. Post-balance-sheet-date issuance of a long-term obligation or equity securities. After the date of an entity's balance sheet but before that balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), a long-term obligation or equity securities have been issued for the purpose of refinancing the short-term obligation on a long-term basis. If equity securities have been issued, the short-term obligation, although excluded from current liabilities, shall not be included in owners' equity.
- b. Financing agreement. Before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), the entity has entered into a financing agreement that clearly permits the entity to refinance the short-term obligation on a long-term basis on terms that are readily determinable, and all of the following conditions are met:
 1. The agreement does not expire within one year (or operating cycle) from the date of the entity's balance sheet and during that period the agreement is not cancelable by the lender or the prospective lender or investor (and obligations incurred under the agreement are not callable during that period) except for violation of a provision with which compliance is objectively determinable or measurable. For purposes of this Subtopic, violation of a provision means failure to meet a condition set forth in the agreement or breach or violation of a provision such as a restrictive covenant, representation, or warranty, whether or not a grace period is allowed or the lender is required to give notice. Financing agreements cancelable for violation of a provision that can be evaluated differently by the parties to the agreement (such as a material adverse change or failure to maintain satisfactory operations) do not comply with this condition.
 2. No violation of any provision in the financing agreement exists at the balance sheet date and no available information indicates that a violation has occurred thereafter but before the balance sheet is issued

or is available to be issued (as discussed in Section 855-10-25), or, if one exists at the balance sheet date or has occurred thereafter, a waiver has been obtained.

3. The lender or the prospective lender or investor with which the entity has entered into the financing agreement is expected to be financially capable of honoring the agreement.

45-15 Repayment of a short-term obligation before funds are obtained through a long-term refinancing requires the use of current assets. Therefore, if a short-term obligation is repaid after the balance sheet date and subsequently a long-term obligation or equity securities are issued whose proceeds are used to replenish current assets before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), the short-term obligation shall not be excluded from current liabilities at the balance sheet date. See Example 5 (paragraph 470-10-55-33) for an illustration of this guidance.



Question 3.6.60

What factors does a debtor consider in evaluating whether it has the intent and ability to refinance on a long-term basis?

Interpretive response: A debtor classifies a short-term obligation as noncurrent if it has the intent and ability to refinance the obligation on a long-term basis. The debtor’s intent must be supported by a demonstrated ability to consummate the refinancing through one of the two ways discussed below. [470-10-45-14]

Post-balance sheet issuance of a long-term debt obligation or equity securities

Description	Additional considerations
<p>Occurs when: [470-10-45-14(a)]</p> <ul style="list-style-type: none"> — debtor issues a long-term debt obligation or equity securities after the reporting date but before the financial statements are issued (available to be issued); and — such funds are used (or will be used) to refinance the short-term obligation on a long-term basis. 	<p>Sequencing of the issuance of long-term debt and the repayment or refinancing of short-term debt could impact the classification. See ‘Accounting classification’ below for further details.</p>
<p>See Examples 3.6.20 and 3.6.30 for additional discussion.</p>	

Financing agreement

Description	Additional considerations
<p>Occurs when the debtor enters into a financing agreement for which funds have not yet been received before the financial statements are issued (available to be issued). The agreement’s terms must clearly permit the debtor to use the proceeds from the financing</p>	<p>Certain conditions must be met for a financing agreement to support a debtor’s intent and ability to refinance an obligation, as further explained below.</p>

Description	Additional considerations
<p>agreement to refinance the short-term obligation on a long-term basis on terms that are readily determinable. However, the financing agreement is not required to explicitly reference the short-term obligation.</p> <p>Examples of such financing agreements are a credit facility, an agreement to raise capital and a forward sale of debt or equity securities. In the context of an agreement to raise capital, the debtor should assess whether it has the unilateral ability to draw on the agreement and must not be precluded by the agreement from using the proceeds to refinance the short-term obligation.</p>	<p>See also Question 3.6.75 for considerations when the financing agreement is held by or with a parent entity.</p>

For a financing agreement to support a debtor’s intent and ability to refinance an obligation, all of the following conditions (A to D) must be met (for both debt and equity agreements). [470-10-45-14(b)]

Condition	Additional considerations
<p>A: The financing agreement does not expire within one year (or operating cycle, if applicable) of the debtor’s reporting date and during that period:</p> <ul style="list-style-type: none"> — the financing agreement is not cancelable by the creditor or the prospective creditor; and — obligations incurred under the financing agreement are not callable by the lender – except for violation of a provision with which compliance is objectively determinable or measurable. 	<p>If the financing agreement has a subjective acceleration clause, the obligation cannot be classified as noncurrent.</p> <p>Unlike Step 2A (see Question 3.6.10), the analysis of a subjective acceleration clause in a financing agreement to refinance a short-term obligation does not consider the likelihood of acceleration. Therefore, even if exercise of the subjective acceleration clause is remote, the debt cannot be classified as noncurrent.</p>
<p>B: Regarding violations of any provisions of the financing agreement:</p> <ul style="list-style-type: none"> — the debtor is not in violation of any provision in the financing agreement at the reporting date; — no available information indicates that a violation has occurred before the financial statements are issued (available to be issued); and — the debtor expects to comply with all provisions of the financing agreement during the year following the reporting date. <p>However, see criterion C if the debtor has violated any of the provisions of the financing agreement.</p>	<p>Compliance with the provisions of the financing agreement, including the amount of availability under the financing agreement, must be objectively determinable.</p> <p>We believe a debtor should assess compliance with the new long-term obligation or financing agreement’s terms at the issuance date in a manner consistent with the presentation guidance for long-term debt with covenants under paragraph 470-10-45-1.</p> <p>In summary, this means the debtor should determine whether it is probable that it will fail to comply with any of the provisions of the new arrangement’s terms and allow the creditor to demand</p>

Condition	Additional considerations
	repayment of the debt within one year of the reporting date (see Question 3.6.70).
C: If a violation of any provisions of the financing agreement exists at the reporting date or occurs thereafter before the financial statements are issued (available to be issued), the debtor must either cure the violation or obtain a waiver from the creditor before issuance of the financial statements.	This criterion is not met if the creditor has the ability to cancel the agreement or prevent the debtor from exercising its rights under the agreement after expiration of a grace period or after notice to the debtor or both (see section 3.6.40).
D: The creditor or the prospective creditor with which the debtor has entered into the financing agreement is financially capable of honoring the agreement.	
See Questions 3.6.70 to 3.6.90 for additional discussion.	

Conclusions

If either of these conditions (i.e. post-balance sheet issuance or a financing agreement) support the debtor’s intent to refinance the short-term debt obligation on a long-term basis, the obligation is classified as a noncurrent liability. Otherwise, it is classified as a current liability.

Further, repayment of a short-term obligation before funds are obtained through a long-term refinancing requires the use of current assets. If a short-term obligation is repaid after the reporting date, it is presented as a current liability as of the reporting date if subsequent to that repayment a long-term debt obligation or equity securities are issued whose proceeds are used to replenish current assets before the financial statements are issued (available to be issued). The sequence of events in such a scenario is a relevant factor when determining appropriate classification. See Subtopic 470-10’s Example 5, reproduced below.

The relevance of the sequence of events is illustrated in the following examples:

- Example 3.6.10 (funds are obtained before the reporting date to repay a short-term obligation);
- Subtopic 470-10’s Example 5 (reproduced after Example 3.6.10) (funds obtained after the reporting date to repay a short-term obligation).



Example 3.6.10

Funds obtained on a long-term basis before the reporting date to be used to repay a short-term obligation

Debtor has a \$50 million note with a maturity date of March 31, Year 2. Debtor’s year-end is December 31. On December 1, Year 1, Debtor enters into

a debt agreement with Bank and borrows \$200 million, which matures on December 1, Year 4.

At December 31, Year 1, Debtor asserts that it will use \$50 million of the \$200 million borrowed from Bank to repay the note payable due March 31, Year 2. The new debt of \$200 million is classified as noncurrent as of December 31, Year 1.

Funds obtained on a long-term basis before the reporting date are excluded from current assets if the obligation is excluded from current liabilities. Therefore, the classification of the cash received before the reporting date aligns with the classification of the related obligation that it is intended to be used to repay. [470-10-45-13]

Debtor has the intent and ability to repay the note payable (short-term obligation) with the newly issued debt (long-term obligation). Therefore, it classifies the \$50 million note payable as a noncurrent liability and also classifies the \$50 million of cash to be used to repay the note payable as a noncurrent asset.

However, if Debtor classifies the \$50 million note as a current liability (because it is due within three months of the reporting date) then the \$200 million of cash received from the new debt issuance is also classified as current.



Excerpt from ASC 470-10

- > Example 5: Classification of a Short-Term Obligation Repaid Before Being Replaced by a Long-Term Security

55-33 This Example illustrates the guidance in paragraph 470-10-45-15.

55-34 This Example has the following assumptions:

- An Entity has issued \$3,000,000 of short-term commercial paper during the year to finance construction of a plant.
- At June 30, 1976, the Entity's fiscal year end, the Entity intends to refinance the commercial paper by issuing long-term debt. However, because the Entity temporarily has excess cash, in July 1976 it liquidates \$1,000,000 of the commercial paper as the paper matures.
- In August 1976, the Entity completes a \$6,000,000 long-term debt offering.
- Later during the month of August, it issues its June 30, 1976, financial statements.
- The proceeds of the long-term debt offering are to be used to do all of the following:
 - Replenish \$1,000,000 in working capital
 - Pay \$2,000,000 of commercial paper as it matures in September 1976
 - Pay \$3,000,000 of construction costs expected to be incurred later that year to complete the plant.

55-35 The \$1,000,000 of commercial paper liquidated in July would be classified as a current liability in the Entity's balance sheet at June 30, 1976. The \$2,000,000 of commercial paper liquidated in September 1976 but

refinanced by the long-term debt offering in August 1976 would be excluded from current liabilities in balance sheets at the end of June 1976, July 1976, and August 1976. It should be noted that the existence of a financing agreement at the date the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) rather than a completed financing at that date would not change these classifications.

55-36 At the end of August 1976, \$2,000,000 of cash would be excluded from current assets or, if included in current assets, a like amount of debt would be classified as a current liability.

Intent and ability to refinance demonstrated by post-balance sheet date issuance of long-term debt or equity securities



Excerpt from ASC 470-10

> Intent and Ability to Refinance on a Long-Term Basis

45-16 If an entity's ability to consummate an intended refinancing of a short-term obligation on a long-term basis is demonstrated by post-balance-sheet-date issuance of a long-term obligation or equity securities (see paragraph 470-10-45-14(a)), the amount of the short-term obligation to be excluded from current liabilities shall not exceed the proceeds of the new long-term obligation or the equity securities issued.

Under Step 3 of the debt classification framework (see Question 3.6.10), a debtor can demonstrate the intent and ability to refinance a short-term obligation by issuing a long-term obligation or equity securities after the reporting date. [\[470-10-45-14\(a\)\]](#)



Example 3.6.20

Short-term debt refinanced as a long-term obligation

Debtor has a \$10 million note with a maturity date of September 30, Year 5. Debtor's fiscal year-end is December 31. Debtor is in compliance with the terms of the note at December 31, Year 4, including a minimum working capital requirement of \$5 million.

On January 25, Year 5, before the issuance of its December 31, Year 4 financial statements, Debtor and Creditor modify the terms of the note. The modification extends the maturity date of the loan to September 30, Year 6 if Debtor maintains at least \$5 million of working capital at each reporting date in Year 5. There are no other provisions in the agreement that would require Debtor to classify the note as a current liability in its December 31, Year 4 financial statements. The working capital requirement is deemed objectively determinable.

Debtor's working capital as of December 31, Year 4 exceeds \$5 million. Based on management's forecast, Debtor expects to comply with the working capital requirement through at least December 31, Year 5.

Debtor classifies the note as noncurrent because:

- it entered into a finance agreement before the financial statements are issued;
- the new agreement is longer than one year from the reporting date of December 31, Year 4;
- the new agreement's working capital provision is objectively determinable; and
- Debtor expects to be in compliance with the working capital provision during the one-year period from the reporting date.

Debtor discloses the terms of the modified agreement in its December 31, Year 4 financial statements (see section 3.8).



Example 3.6.30

Repay a portion of a short-term obligation with a long-term obligation issued after the reporting date

At December 31, Year 4, Debtor has \$5 million in loans payable with a maturity date of June 30, Year 5.

On January 1, Year 5, Debtor issues \$4 million in notes payable, maturing at January 1, Year 8. The proceeds from the notes payable are used to repay \$4 million of the loans payable balance before the financial statements are issued.

Debtor classifies \$4 million of the notes payable as a noncurrent liability, and the remaining \$1 million of the loans payable as a current liability at December 31, Year 4.

Intent and ability to refinance on a long-term basis demonstrated by the existence of a financing agreement



Excerpt from ASC 470-10

> Intent and Ability to Refinance on a Long-Term Basis

45-17 If ability to refinance is demonstrated by the existence of a financing agreement (see paragraph 470-10-45-14(b)), the amount of the short-term obligation to be excluded from current liabilities shall be reduced to the amount available for refinancing under the agreement if the amount available is less than the amount of the short-term obligation.

45-18 The amount to be excluded shall be reduced further if information (such as restrictions in other agreements or restrictions as to transferability of funds) indicates that funds obtainable under the agreement will not be available to liquidate the short-term obligation.

45-19 Further, if amounts that could be obtained under the financing agreement fluctuate (for example, in relation to the entity's needs, in proportion to the value of collateral, or in accordance with other terms of the agreement), the amount to be excluded from current liabilities shall be limited to a reasonable estimate of the minimum amount expected to be available at any date from the scheduled maturity of the short-term obligation to the end of the fiscal year (or operating cycle). If no reasonable estimate can be made, the entire outstanding short-term obligation shall be included in current liabilities.

45-20 The entity may intend to seek an alternative source of financing rather than to exercise its rights under the existing agreement when the short-term obligation becomes due. The entity must intend to exercise its rights under the existing agreement, however, if that other source does not become available. The intent to exercise may not be present if the terms of the agreement contain conditions or permit the prospective lender or investor to establish conditions, such as interest rates or collateral requirements that are unreasonable to the entity.

> Transactions after the Balance Sheet Date

45-21 Replacement of a short-term obligation with another short-term obligation after the date of the balance sheet but before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25) is not, by itself, sufficient to demonstrate an entity's ability to refinance the short-term obligation on a long-term basis. If, for example, the replacement is made under the terms of a revolving credit agreement that provides for renewal or extension of the short-term obligation for an uninterrupted period extending beyond one year (or operating cycle) from the date of the balance sheet, the revolving credit agreement must meet the conditions in paragraph 470-10-45-14(b) to justify excluding the short-term obligation from current liabilities. Similarly, if the replacement is a rollover of commercial paper accompanied by a standby credit agreement, the standby agreement must meet the conditions in that paragraph to justify excluding the short-term obligation from current liabilities.

Under Step 3 of the debt classification framework (see Question 3.6.10), refinancing a short-term obligation before the financial statements are issued (available to be issued) demonstrates the debtor's intent and ability as of the reporting date to refinance the obligation on a long-term basis.

To demonstrate the ability through a financing agreement, the debtor must meet the conditions listed in paragraph 470-10-45-14(b) (see Question 3.6.60). However, if the replacement obligation is also short-term, the refinancing transaction may not be sufficient to demonstrate the debtor's ability to refinance the debt on a long-term basis. This section illustrates this concept and explains its application. [\[470-10-45-21\]](#)



Question 3.6.70

When is a financing agreement sufficient to classify a short-term obligation as noncurrent?

Interpretive response: For a debtor to classify a short-term obligation as noncurrent based on the existence of a financing agreement, compliance with the financing agreement's terms must be objectively determinable (Condition A in Question 3.6.60). Financing agreements that are cancelable or subject to a reduction in availability based on different evaluations by the two parties do not comply with this requirement. Specific, quantifiable criteria in the financing agreement defining a material adverse change (e.g. a 10% decrease in working capital, sales and earnings) is considered objectively determinable or measurable. [470-10-45-14(b)(1)]

Provisions that are considered to be objectively determinable allow a short-term obligation to be classified as a noncurrent liability if the other required conditions in paragraph 470-10-45-14(b) are met (Conditions B – D in Question 3.6.60).

When evaluating the terms of the financing agreement, we believe a debtor should consider:

- its ability to comply with the objectively determinable or measurable provisions in the agreement at the reporting date; and
- whether it expects to comply with the provisions of the agreement for a period of one year from the reporting date.

The debtor should determine whether the financing agreement specifies a level of operating results, financial position or other measurements that exceed those it previously has attained. If this is the case, the debtor should evidence a very high level of assurance that it will meet the specified provisions to allow classification of the obligation as noncurrent under the provisions of paragraph 470-10-45-14(b).



Question 3.6.75

Does a parent's commitment of support represent a financing agreement that is sufficient to classify a subsidiary's short-term obligation as noncurrent?

Interpretive response: Yes, if the parent's commitment of support meets the requisite conditions (Conditions A – D in Question 3.6.60), it would demonstrate the parent's intent and ability to refinance the subsidiary's short-term obligations on a long-term basis. The parent's commitment of support can be to provide either long-term debt or a capital contribution to the subsidiary.

A parent's commitment must be documented to demonstrate its intent to provide financing to the subsidiary but is not required to be in the form of a formal refinancing agreement between the parent and its subsidiary. The documented commitment must meet the conditions for a financing agreement to support the subsidiary's intent and ability to refinance an obligation (Conditions A – D in Question 3.6.60).

A parent's ability to fulfill its commitment must be evidenced as well (consistent with Condition D in Question 3.6.60), whether the parent will provide the financing by using its working capital or drawing down on its own external financing agreement.

For example, a parent may enter into an external financing arrangement that allows it to provide intercompany financing to its subsidiaries, thereby allowing the subsidiaries to refinance their short-term obligations. If that external financing agreement meets the requisite conditions, it would demonstrate the parent's ability to support its capital commitment.



Question 3.6.80

How does a subjective provision in a financing agreement affect a debtor's ability to classify the debt as noncurrent?

Interpretive response: A subjective provision (i.e. a subjective acceleration clause) allows the creditor to withdraw from the agreement at its own discretion. For example, a provision may allow a creditor to withdraw from the agreement if there is a material adverse change in the debtor's financial position or operations, or if the debtor fails to maintain satisfactory operations. Such a provision is considered subjective because the creditor's definition of 'material adverse' or 'satisfactory operations' is not objectively measurable by the terms of the agreement. In this example, because the provisions are not objectively determinable, the debtor would classify the debt as a current liability. [470-10-45-14(b)]

A subjective acceleration clause might not be a separate part of the financing agreement in the form of a traditional material adverse change clause or within the agreement's specified events of default. Instead, it may be implicit in other aspects of the agreement – e.g. a creditor's ability to reduce loan availability at its discretion under the financing agreement.

A debtor may not assess the probability that the creditor will cancel the agreement or reduce available credit based on the subjective provision in the financing agreement. Therefore, the existence of a subjective provision in a financing agreement prohibits reclassification of a short-term obligation as a noncurrent liability if the financing agreement was the basis for concluding that the debtor has the ability and intent to refinance the short-term obligation on a long-term basis. [470-10-55-1]



Question 3.6.90

Is a provision in a refinancing transaction subjective if it requires a debtor to represent that there has been no material adverse change since the last reporting date?

Background: Assume that Debtor classifies a short-term obligation as noncurrent because it plans to refinance the obligation after the reporting date. It enters into a new debt agreement after the reporting date but before it issues its financial statements. Under the new agreement's terms, Debtor is required to represent to the lender that no material adverse change occurred between the reporting date and the execution date of the agreement.

Interpretive response: When there is a date-limited representation required only at the time of and as a condition to entering into the financing agreement, both the debtor and the creditor have the ability to evaluate whether a material adverse change occurred before executing the agreement.

Under such a provision, the debtor must represent that a material adverse change has not occurred between the most recent reporting date and the execution date of the financing agreement. We believe an arrangement is not subjectively cancelable when a representation is required solely before execution of the financing agreement. Therefore, such a provision does not preclude the financing agreement from supporting the assertion by the debtor of its intent and ability to refinance a short-term obligation on a long-term basis.

In contrast, we believe an arrangement is subjectively cancelable if the debtor is required to make similar representations on an ongoing basis after the agreement is executed. In that case, the agreement would not support the debtor's ability to classify the short-term obligation as noncurrent.

FASB example

The following FASB example illustrates several scenarios in which a debtor refinances the portion of a long-term obligation that is currently due.



Excerpt from ASC 470-10

• > Example 4: Current Maturity of Long-Term Debt and Notes Payable to Be Refinanced

55-13 The following Cases illustrate various scenarios for refinancing the current portion of long-term debt and notes payable as discussed in paragraphs 470-10-45-13 through 45-20:

- a. Entity refinances on long-term basis the current maturity of long-term debt and notes payable (Case A).
- b. Laws prohibit the transfer of funds (Case B).
- c. Entity issues debentures to liquidate the debt (Case C).
- d. Entity negotiates a revolving credit agreement (Case D).

- e. Entity negotiates a revolving credit agreement with borrowing limits (Case E).
- f. Entity refinances commercial paper (Case F).
- g. Case illustrates balance sheet presentation (Case G).

55-14 The Cases in this Example do not comprehend all possible circumstances and do not include all the disclosures that would typically be made regarding long-term debt or current liabilities.

55-15 Cases A through G share all of the following assumptions:

- a. Entity A's fiscal year-end is December 31, 19X5.
- b. The date of issuance of the December 31, 19X5 financial statements is March 31, 19X6; the Entity's practice is to issue a classified balance sheet.
- c. At December 31, 19X5, short-term obligations include \$5,000,000 representing the portion of 6 percent long-term debt maturing in February 19X6 and \$3,000,000 of 9 percent notes payable issued in November 19X5 and maturing in July 19X6.
- d. The Entity intends to refinance on a long-term basis both the current maturity of long-term debt and the 9 percent notes payable.
- e. Accounts other than the long-term debt maturing in February 19X6 and the notes payable maturing in July 19X6 are as follows.

Current assets	\$30,000,000
Other assets	\$50,000,000
Accounts payable and accruals	\$10,000,000
Other long-term debt	\$25,000,000
Shareholders' equity	\$37,000,000

- f. Unless otherwise indicated, the Cases also assume that the lender or prospective lender is expected to be capable of honoring the agreement, that there is no evidence of a violation of any provision, and that the terms of borrowings available under the agreement are readily determinable.

•• > Case A: Entity Refinances on Long-Term Basis the Current Maturity of Long-Term Debt and Notes Payable

55-16 The Entity negotiates a financing agreement with a commercial bank in December 19X5 for a maximum borrowing of \$8,000,000 at any time through 19X7 with the following terms:

- a. Borrowings are available at Entity A's request for such purposes as it deems appropriate and will mature three years from the date of borrowing.
- b. Amounts borrowed will bear interest at the bank's prime rate.
- c. An annual commitment fee of 1/2 of 1 percent is payable on the difference between the amount borrowed and \$8,000,000.
- d. The agreement is cancelable by the lender only if any of the following occur:
 1. The Entity's **working capital**, excluding borrowings under the agreement, falls below \$10,000,000.
 2. The Entity becomes obligated under lease agreements to pay an annual rental in excess of \$1,000,000.

3. Treasury stock is acquired without the prior approval of the prospective lender.
4. The Entity guarantees indebtedness of unaffiliated persons in excess of \$500,000.

55-17 The Entity's intention to refinance meets the condition specified by paragraph 470-10-45-14. Compliance with the provisions listed in (d) of the preceding paragraph is objectively determinable or measurable; therefore, the condition specified by paragraph 470-10-45-14(b)(1) is met. The proceeds of borrowings under the agreement are clearly available for the liquidation of the 9 percent notes payable and the long-term debt maturing in February 19X6. Both obligations, therefore, would be classified as other than current liabilities.

55-18 Following are the liability section of Entity A's balance sheet at December 31, 19X5, and the related note disclosures required by this Subtopic, based on the information in paragraphs 470-10-55-15 through 55-16. Because the balance sheet is issued subsequent to the February 19X6 maturity of the long-term debt, the note describes the refinancing of that obligation.

	December 31, 19X5
Current Liabilities:	
Accounts payable and accruals	\$ 10,000,000
Total Current Liabilities	10,000,000
Long-Term Debt:	
9% notes payable (Note A)	3,000,000 ^(a)
6% debt due February 19X6 (Note A)	5,000,000 ^(a)
Other long-term debt	25,000,000
Total Long-Term Debt	33,000,000
Total Liabilities	\$ 43,000,000

(a) These obligations may also be shown in captions distinct from both current liabilities and long-term debt, such as Interim Debt, Short-Term Debt Expected to Be Refinanced, and Intermediate Debt.

Note A

The Entity has entered into a financing agreement with a commercial bank that permits the Entity to borrow at any time through 19X7 up to \$8,000,000 at the bank's prime rate of interest. The Entity must pay an annual commitment fee of 1/2 of 1 percent of the unused portion of the commitment. Borrowings under the financing agreement mature three years after the date of the loan. Among other things, the agreement prohibits the acquisition of treasury stock without prior approval by the bank, requires maintenance of working capital of \$10,000,000 exclusive of borrowings under the agreement, and limits the annual rental under lease agreements to \$1,000,000. In February 19X6, the Entity borrowed \$5,000,000 at 8 percent and liquidated the 6 percent long-term debt, and it intends to borrow additional funds available under the agreement to refinance the 9 percent notes payable maturing in July 19X6.

- • > Case B: Laws Prohibit the Transfer of Funds

55-19 A foreign subsidiary of the Entity negotiates a financing agreement with its local bank in December 19X5. Funds are available to the subsidiary for its unrestricted use, including loans to affiliated entities; other terms are identical

to those cited in Case A. Local laws prohibit the transfer of funds outside the country.

55-20 The requirement of paragraph 470-10-45-14(b)(1) is met because compliance with the provisions of the agreement is objectively determinable or measurable. Because of the laws prohibiting the transfer of funds, however, the proceeds from borrowings under the agreement are not available for liquidation of the debt maturing in February and July 19X6. Accordingly, both the 6 percent debt maturing in February 19X6 and the 9 percent notes payable maturing in July 19X6 would be classified as current liabilities.

• • > Case C: Entity Issues Debentures to Liquidate the Debt

55-21 In this Case, the Entity issues \$8,000,000 of 10-year debentures to the public in January 19X6. The Entity intends to use the proceeds to liquidate the \$5,000,000 debt maturing February 19X6 and the \$3,000,000 of 9 percent notes payable maturing July 19X6. In addition, assume the debt maturing February 19X6 is paid before the issuance of the balance sheet, and the remaining proceeds from the sale of debentures are invested in a U.S. Treasury note maturing the same day as the 9 percent notes payable.

55-22 Because the Entity refinanced the long-term debt maturing in February 19X6 in a manner that meets the conditions set forth in paragraph 470-10-45-14, that obligation would be excluded from current liabilities. In addition, the 9 percent notes payable maturing in July 19X6 would also be excluded because the Entity has obtained funds expressly intended to be used to liquidate those notes and not intended to be used in current operations. In balance sheets after the date of sale of the debentures and before the maturity date of the notes payable, the Entity would exclude the notes payable from current liabilities if the U.S. Treasury note is excluded from current assets (see paragraph 210-10-45-4).

55-23 If the debentures had been sold before January 1, 19X6, the \$8,000,000 of obligations to be paid would be excluded from current liabilities in the balance sheet at that date if the \$8,000,000 in funds were excluded from current assets.

55-24 If, instead of issuing the 10-year debentures, the Entity had issued \$8,000,000 of equity securities and all other facts in this Case remained unchanged, both the 6 percent debt due February 19X6 and the 9 percent notes payable due July 19X6 would be classified as liabilities other than current liabilities, such as Indebtedness Due in 19X6 Refinanced in January 19X6.

• • > Case D: Revolving Credit Agreement

55-25 In December 19X5 the Entity negotiates a revolving credit agreement providing for unrestricted borrowings up to \$10,000,000. Borrowings will bear interest at 1 percent over the prevailing prime rate of the bank with which the agreement is arranged but in any event not less than 8 percent, will have stated maturities of 90 days, and will be continuously renewable for 90-day periods at the Entity's option for 3 years provided there is compliance with the terms of the agreement. Provisions of the agreement are similar to those cited in paragraph 470-10-55-16(d). Further, the Entity intends to renew obligations incurred under the agreement for a period extending beyond one year from the

balance sheet date. There are no outstanding borrowings under the agreement at December 31, 19X5.

55-26 In this instance, the long-term debt maturing in February 19X6 and the 9 percent notes payable maturing in July 19X6 would be excluded from current liabilities because the Entity consummated a financing agreement meeting the conditions set forth in paragraph 470-10-45-14(b) before the issuance of the balance sheet.

• • > Case E: Revolving Credit Agreement with Borrowing Limits

55-27 Assume that the agreement cited in Case D included an additional provision limiting the amount to be borrowed by the Entity to the amount of its inventory, which is pledged as collateral and is expected to range between a high of \$8,000,000 during the second quarter of 19X6 and a low of \$4,000,000 during the fourth quarter of 19X6.

55-28 The terms of the agreement comply with the conditions required by this Subtopic; however, because the minimum amount expected to be available from February to December 19X6 is \$4,000,000, only that amount of short-term obligations can be excluded from current liabilities (see paragraphs 470-10-45-16 through 45-19). Whether the obligation to be excluded is a portion of the currently maturing long-term debt or some portions of both it and the 9 percent notes payable depends on the intended timing of the borrowing.

55-29 If the Entity intended to refinance only the 9 percent notes payable due July 19X6 and the amount of its inventory is expected to reach a low of approximately \$2,000,000 during the second quarter of 19X6 but be at least \$3,000,000 in July 19X6 and thereafter during 19X6, the \$3,000,000 9 percent notes payable would be excluded from current liabilities at December 31, 19X5 (see paragraphs 470-10-45-16 through 45-19).

• • > Case F: Commercial Paper Refinancing

55-30 In lieu of the facts given in paragraph 470-10-55-15(c) through (d), assume that during 19X5 the Entity entered into a contract to have a warehouse built. The warehouse is expected to be financed by issuance of the Entity's commercial paper. In addition, the Entity negotiated a standby agreement with a commercial bank that provides for maximum borrowings equal to the expected cost of the warehouse, which will be pledged as collateral. The agreement also requires that the proceeds from the sale of commercial paper be used to pay construction costs. Borrowings may be made under the agreement only if the Entity is unable to issue new commercial paper. The proceeds of borrowings must be used to retire outstanding commercial paper and to liquidate additional liabilities incurred in the construction of the warehouse. At December 31, 19X5, the Entity has \$7,000,000 of commercial paper outstanding and \$1,000,000 of unpaid construction costs resulting from a progress billing through December 31.

55-31 Because the commercial paper will be refinanced on a long-term basis, either by uninterrupted renewal or, failing that, by a borrowing under the agreement, the commercial paper would be excluded from current liabilities. The \$1,000,000 liability for the unpaid progress billing results from the construction of a noncurrent asset and will be refinanced on the same basis as

the commercial paper and, therefore, it would also be excluded from current liabilities (see paragraph 470-10-45-13).

• • > Case G: Balance Sheet Presentation

55-32 The following are two methods of presenting liabilities in Entity A's balance sheet at December 31, 19X5, assuming the Entity intends to refinance the 6 percent debt maturing in February 19X6 and the 9 percent notes payable maturing in July 19X6 but has not met the conditions required by this Subtopic to exclude those obligations from current liabilities.

Alternative 1	December 31, 19X5
Current Liabilities:	
Accounts payable and accruals	\$ 10,000,000
Notes payable, due July 19X6	3,000,000
6% debt due February 19X6	5,000,000
Total Current Liabilities	18,000,000
Long-Term Debt	25,000,000
Total Liabilities	\$ 43,000,000

Alternative 2	December 31, 19X5	
Current Liabilities:		
Accounts payable and accruals	\$	10,000,000
Short-term debt expected to be refinanced:		
Notes payable, due July 19X6	\$ 3,000,000	
6% debt due February 19X6	5,000,000	8,000,000
Total Current Liabilities		18,000,000
Long-Term Debt		25,000,000
Total Liabilities	\$	43,000,000

3.6.30 Revolving credit agreements and lock-box arrangements



Excerpt from ASC 470-10

> Classification of Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses

45-3 This guidance does not apply to lock-box arrangements that are maintained at the discretion of the borrower.

45-4 Borrowings outstanding under certain revolving credit agreements are considered long-term debt because the borrowings are due at the end of a specified period (for example, 3 years) rather than when short-term notes roll over (for example, every 90 days). Borrowings may be collateralized, but the only note is the overall note signed at the agreement's inception. Some agreements require that the borrower maintain a **lock-box arrangement**. If

borrowings outstanding under the agreement are considered **long-term obligations**, the effect of a subjective acceleration clause on balance sheet classification is determined based on the criteria in paragraph 470-10-45-2. If borrowings outstanding are considered short-term obligations, and the borrower intends to refinance the obligation on a long-term basis, paragraph 470-10-45-13 applies and the debt shall be classified as a current liability because of the existence of the subjective acceleration clause.

45-5 Borrowings outstanding under a revolving credit agreement that includes both a subjective acceleration clause and a requirement to maintain a lock-box arrangement shall be considered short-term obligations. Accordingly, because of the subjective acceleration clause, the debt shall be classified as a current liability unless the conditions in paragraph 470-10-45-14 are met based on an agreement, other than the revolving credit agreement, to refinance the obligation after the balance sheet date on a long-term basis.

45-5A The term lock-box arrangement as used in this guidance refers to any situation in which the borrower does not have the ability to avoid using working capital to repay the amounts outstanding. That is, if the contractual provisions of a loan arrangement require that, in the ordinary course of business and without another event occurring, the cash receipts of a debtor be used to repay the existing obligation, the credit agreement shall be considered a short-term obligation.

45-6 Borrowings outstanding under a revolving credit agreement that includes both a subjective acceleration clause and a requirement to maintain a **springing lock-box arrangement** shall be considered long-term obligations since the remittances do not automatically reduce the debt outstanding without another event occurring. The effect of the agreement's subjective acceleration clause shall be determined based on the provisions of paragraph 470-10-45-2.



Question 3.6.100

How is a revolving credit agreement classified?

Interpretive response: Revolving credit agreements are long-term obligations if they have explicit repayment dates for outstanding borrowings more than one year after the reporting date and do not require a lock-box arrangement (see Question 3.6.120 for a description of a lock-box arrangement). Therefore, absent evidence to the contrary, a debtor classifies such borrowings under the revolving credit agreement as a noncurrent liability. [470-10-45-4]

Subjective acceleration clause

If the credit agreement includes a subjective acceleration clause, the debtor assesses the effect of the subjective acceleration clause under Step 2A of the debt classification framework (see Question 3.6.50).

Clean-up clause/period

If the credit agreement includes a clean-up clause/period, the debtor assesses its effect on the classification of the credit agreement. A clean-up clause typically provides specified periods or dates, before final maturity of the credit agreement, on which all amounts outstanding under the credit agreement must be paid and no amount can be drawn for a specified clean-up period.

For example, a revolving credit agreement may have a maturity date four years from the date of issuance but may require any amounts outstanding on June 15 of each of those years to be paid by that date and no further borrowings may be made until June 30 of each of those years. In our experience, such terms in a revolving credit agreement indicate that outstanding amounts represent a short-term obligation. This is because the debtor must pay off all amounts by June 15 of each year and is not able to borrow under the revolver until June 30 of each year.



Question 3.6.110

How is a revolving credit agreement that requires issuance of short-term notes on each drawdown classified?

Interpretive response: Outstanding borrowings under a revolving credit agreement (even with a remaining period exceeding one year) – that require the debtor to execute notes with a term of less than one year each time funds are drawn – are short-term obligations.

Therefore, the debtor's ability to refinance the short-term obligations under those agreements on a long-term basis is evaluated under Step 3 of the debt classification framework (see Question 3.6.60) to determine classification of the debt as a current or noncurrent liability.



Example 3.6.40

Classification of a short-term revolver

Debtor enters into a revolving credit agreement with Bank on January 1, Year 1 for a maximum aggregate amount of \$10 million, expiring on December 31, Year 3. The terms of the revolver are such that each loan drawn by the borrower is due 90 days from the date of the draw.

At November 30, Year 1, Debtor draws \$5 million from the revolver, for which repayment is due within 90 days (i.e. by February 28, Year 2). As of December 31, Year 1, Debtor has a short-term obligation of \$5 million. This obligation is classified as a current liability even though the revolving credit facility does not expire until Year 3; this is because any amount drawn under the facility is due within 90 days (within a year of the reporting date).

Under the debt classification framework (see Question 3.6.10), Debtor has to demonstrate its intent and ability to refinance a short-term obligation on a long-

term basis if it wants to exclude the short-term obligation from current liabilities on the balance sheet.

Because Debtor has the ability to repay the \$5 million draw from the remaining available funds under the revolving credit agreement, it has to consider its intent and ability to refinance the short-term obligation with another short-term obligation. Debtor has to assess whether the revolving credit agreement meets all the conditions for demonstrating intent and ability through a financing agreement. Otherwise, the \$5 million balance on the revolver would be classified as a current liability as of December 31, Year 1.

For an additional example, see Subtopic 470-10's Example 4, Case D, in section 3.6.20.

Alternative scenario

A revolving credit agreement is collateralized and there is a provision that limits the borrowing capacity to up to a certain percentage of the carrying amount of the collateralized assets at any date. In this scenario, only the amount of borrowing up to the limitation may be excluded from current liabilities, to the extent Debtor can demonstrate its intent and ability to refinance on a long-term basis.

For an example, see Subtopic 470-10's, Case E, in section 3.6.20.



Question 3.6.120

How are debt agreements that include lock-box arrangements (including those with subjective acceleration clauses) classified?

Background: A lock-box arrangement refers to a situation in which payments from customers of the debtor are remitted directly to the creditor and applied toward the amounts outstanding under a revolving credit facility. The contractual provisions of the loan arrangement require that, in the ordinary course of business, the cash receipts of the debtor be used to repay the existing obligation. The debtor may then request a draw down (i.e. an additional new borrowing) under the revolving credit facility for additional cash needs. [470-10-45-5A]

Interpretive response: Current liability. With the lock-box arrangement, the creditor always has first access to the collections and uses those collections to satisfy the revolving credit amount outstanding or a portion thereof. Therefore, these arrangements are considered short-term obligations. This lock-box arrangement differs from the springing lock-box arrangement described in Question 3.6.130. [470-10-45-5]

Nevertheless, a debtor can classify short-term obligations with required lock-box arrangements as noncurrent if it demonstrates the intent and ability to refinance these obligations on a long-term basis (see section 3.6.20).

However, the reclassification of outstanding revolving credit borrowings to noncurrent is precluded if the revolver includes a subjective acceleration clause. In this case, unless the debtor has other financing agreements that

demonstrate its intent and ability to refinance the revolving credit facility on a long-term basis, the amount outstanding on the facility is classified as current because of the subjective acceleration clause. [470-10-45-5]



Question 3.6.130

How is a springing lock-box arrangement classified?

Background: In a springing lock-box arrangement, payments made by the debtor's customers are remitted directly to the creditor. However, the remittances do not automatically reduce the debt outstanding; they only reduce the outstanding borrowings if the creditor exercises the subjective acceleration clause or another event of default occurs.

Interpretive response: A revolving credit facility with contractual repayment terms beyond one year from the reporting date that includes both a subjective acceleration clause and a requirement to maintain a springing lock-box arrangement is a long-term obligation. This conclusion assumes there is no effect to the classification from the subjective acceleration clause; see Step 3 of the debt classification framework and Question 3.6.50. [470-10-45-6]

3.6.40 On demand or callable debt



Excerpt from ASC 470-10

> Classification of Debt That Includes Covenants

45-1 Some long-term loans require compliance with certain covenants that must be met on a quarterly or semiannual basis. If a covenant violation occurs that would otherwise give the lender the right to call the debt, a lender may waive its call right arising from the current violation for a period greater than one year while retaining future covenant requirements. Unless facts and circumstances indicate otherwise, the borrower shall classify the obligation as noncurrent, unless both of the following conditions exist:

- a. A covenant violation that gives the lender the right to call the debt has occurred at the balance sheet date or would have occurred absent a loan modification.
- b. It is probable that the borrower will not be able to cure the default (comply with the covenant) at measurement dates that are within the next 12 months.

See Example 1 (paragraph 470-10-55-2) for an illustration of this classification guidance.

> Due on Demand Loan Arrangements

45-9 Loan agreements may specify the debtor's repayment terms but also enable the creditor, at his discretion, to demand payment at any time. Those loan arrangements may have wording such as either of the following:

- a. "The term note shall mature in monthly installments as set forth therein or on demand, whichever is earlier."
- b. "Principal and interest shall be due on demand, or if no demand is made, in quarterly installments beginning on...."

45-10 The current liability classification shall include obligations that, by their terms, are due on demand or will be due on demand within one year (or **operating cycle**, if longer) from the balance sheet date, even though liquidation may not be expected within that period. The demand provision is not a subjective acceleration clause as discussed in paragraph 470-10-45-2.

> Callable Debt

45-11 Current liabilities shall include long-term obligations that are or will be callable by the creditor either because the debtor's **violation of a provision** of the debt agreement at the balance sheet date makes the **obligation callable** or because the violation, if not cured within a specified grace period, will make the obligation callable. Accordingly, such callable obligations shall be classified as current liabilities unless either of the following conditions is met:

- a. The creditor has waived or subsequently lost (for example, the debtor has cured the violation after the balance sheet date and the obligation is not callable at the time the financial statements are issued or are available to be issued [as discussed in Section 855-10-25]) the right to demand repayment for more than one year (or operating cycle, if longer) from the balance sheet date. If the obligation is callable because of violations of certain provisions of the debt agreement, the creditor needs to waive its right with regard only to those violations.
- b. For long-term obligations containing a grace period within which the debtor may cure the violation, it is **probable** that the violation will be cured within that period, thus preventing the obligation from becoming callable.

45-12 Drawing a distinction between significant violations of critical conditions and technical violations is not practicable. A violation that a debtor considers to be technical may be considered critical by the creditor. Furthermore, a creditor may choose to use a technical violation as a means to withdraw from its lending relationship with the debtor. If the violation is considered insignificant by the creditor, then the debtor should be able to obtain a waiver as discussed in the preceding paragraph.

Debt instruments commonly include covenants and other provisions that require the debtor to perform in a certain manner or prohibit it from conducting certain activities. The debt instrument may allow the creditor to demand immediate repayment in the event of default, which occurs when the debtor violates a covenant or other provision of the debt instrument. Covenants or other provisions of the debt instrument may be related to financial conditions (e.g. a minimum current ratio requirement) or nonfinancial conditions (e.g. all trucks owned by the borrower must be currently registered and insured).

If a covenant violation, whether financial or nonfinancial, permits the creditor to demand payment, the debt is a current liability even if otherwise it is a long-term obligation (see the debt classification framework at Question 3.6.10) unless: [470-10-45-11]

- the creditor has waived or subsequently lost the right to demand repayment for more than one year from the reporting date; or
- if the obligation contains a grace period, it is probable that the violation will be cured within that period.

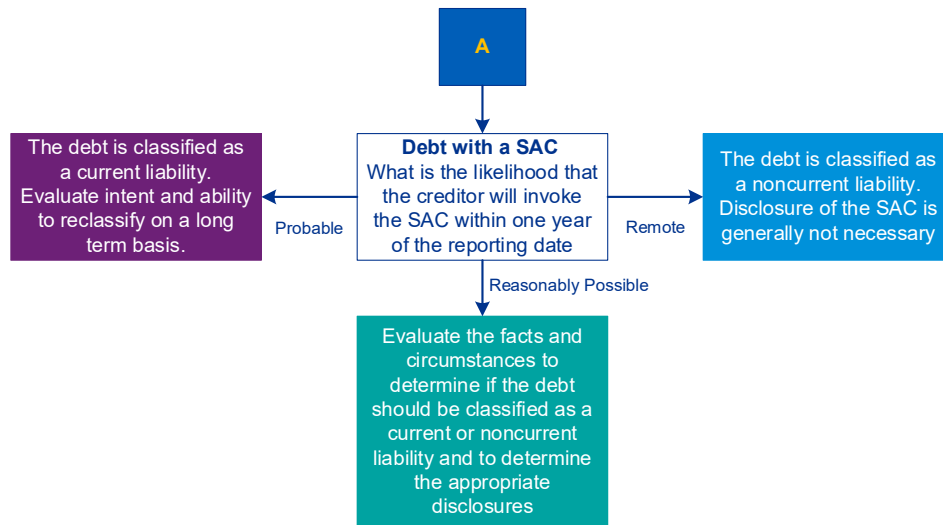
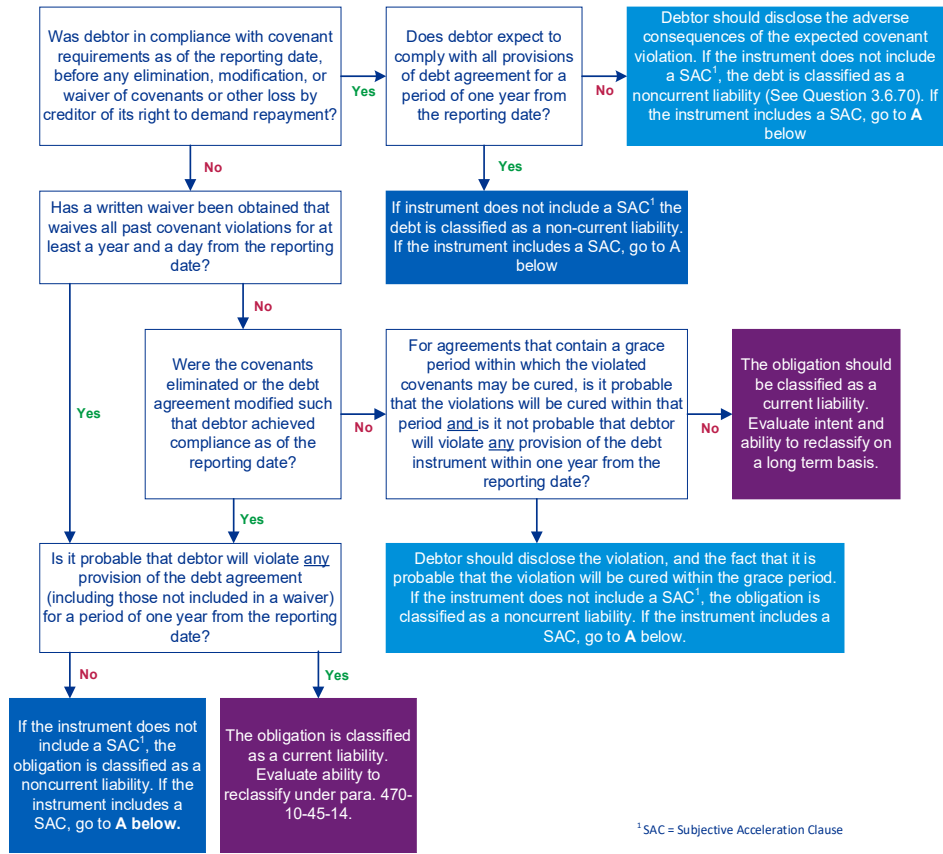


Question 3.6.140

How is debt classified when it allows the creditor to demand repayment for a covenant violation?

Interpretive response: The following decision tree contains a classification framework for debt with an objective covenant(s) that allows the creditor to demand payment on a covenant violation. This decision tree assumes that the debt embodies a long-term obligation before considering the effects of the debt covenant(s) or any subjective acceleration clauses.

A debtor first evaluates the debt classification under the general debt classification framework in Question 3.6.10. If the general debt classification framework indicates that the debt embodies a short-term obligation, there is no need to apply the decision tree because the debt is classified as a current liability unless the short-term debt is refinanced on a long-term basis.





Question 3.6.150

What is a debtor's responsibility for monitoring its compliance with a debt covenant?

Interpretive response: Current or future noncompliance with a debt covenant can affect the debt's classification. Therefore, a debtor is required to determine as of each reporting date whether it violated a covenant (financial or nonfinancial) during the reporting period and whether it anticipates violating a covenant (financial or nonfinancial) in a future period (one year from the reporting date).

In practice, to appropriately monitor current and future projected compliance, a debtor needs to distinguish between point-in-time and continuous covenant requirements.

Compliance with point-in-time covenants is measured as of specified compliance dates – e.g. the debtor may be required to comply with a minimum net worth covenant at the end of each quarter.

Continuous covenants require the debtor to maintain compliance at all times during a specified period – e.g. the debtor may be required to maintain its property insurance in force.

Debt instruments may also include cross covenants in which a default under one agreement results in a default under another agreement (see Example 3.6.140).



Question 3.6.160

How is debt classified when the debtor is in compliance with the debt covenant at the reporting date, but it is probable that it will violate it in a future period?

Interpretive response: If it is probable that a debtor will violate its debt covenants in a future period, but is in compliance with its debt covenant at the reporting date, it may classify a debt as noncurrent if the debt is not currently due within one year from the reporting date. [\[470-10-45-1\]](#)

However, the debtor should disclose the adverse consequences of its probable failure to comply with the covenant in the following period(s) in the notes to the financial statements. SEC registrants should also consider discussion in MD&A. See section 3.8 for disclosure requirements. [\[S-X Rule 4-08\(c\)\]](#)



Question 3.6.170

Can a debtor assume its future compliance will cure a previous debt covenant violation?

Interpretive response: In the absence of specific provisions in the debt agreement for curing covenant violations, we believe a debtor should not assume that future compliance will cure a previous covenant violation. Determining compliance with a covenant that is not well defined ordinarily requires clarification from the creditor or legal analysis. In these situations, the debtor should obtain clarification of the covenant (preferably in writing) from the creditor.



Question 3.6.180

If a debtor expects to cure a covenant violation within the grace period, can it continue to classify the debt as noncurrent?

Interpretive response: It depends. If a debt covenant has been violated, a debtor can continue to classify a debt as noncurrent if: [\[470-10-45-11\(b\)\]](#)

- it is probable that the violation will be cured during the grace period; and
- it is not probable that the debtor will violate that (or any other) covenant again (thereby allowing the creditor to call the debt) within one year of the reporting date.

If a debtor classifies debt as a noncurrent liability based on its right and the expectation that it can cure a covenant violation, it should consider the disclosure requirements in paragraphs 235-10-S99-1 and 470-10-50-2 (section 3.8.10).

The same analysis applies when there would have been a covenant violation if not for a modification of the debt agreement. The modification is similar to the creditor losing its right to demand payment by agreeing to enter into a modified agreement to avoid the debtor's covenant violation. The debtor can classify the debt as noncurrent only if it determines it is not probable that it will violate any provisions of the debt agreement that will allow the creditor to call the loan within one year of the reporting date.

Note: Even if a covenant provides a grace period for curing a violation, the covenant is considered to be violated for purposes applying the classification guidance in Question 3.6.140.

**Question 3.6.190****How is debt classified when a covenant violation is waived by the creditor?**

Interpretive response: Generally, a debt may be classified as noncurrent when a debt covenant has been violated but the creditor has either: [470-10-45-11(a)]

- waived the violation before issuance of the debtor's financial statements; or
- lost its right to demand repayment for more than one year from the reporting date.

However, even with a waiver, the debt is classified as current if it is probable there will be any covenant violation (of the waived or any other covenant) that will allow the creditor to call the loan within one year of the reporting date.

The same analysis applies when there would have been a covenant violation if not for a modification of the debt agreement.

Examples involving debt covenant violations**Excerpt from ASC 470-10**

- > Example 1: Classification of Long-Term Debt That Includes Covenants

55-2 This Example illustrates the guidance in paragraph 470-10-45-1 for the classification of long-term debt when a debt covenant violation is waived by a lender for a period greater than a year.

55-3 A borrower has a long-term loan that requires compliance with certain covenants, such as maintenance of a minimum current ratio, minimum debt-to-equity ratio, or minimum level of shareholders' equity. The borrower must meet the covenants on a quarterly or semiannual basis. At one of the compliance dates, the borrower violates a covenant. That violation gives the lender the right to call the debt. The lender waives that right for a period greater than one year but retains the future covenant requirements.

55-4 The issue is whether the waiver of the lender's rights resulting from the violation of the covenant with the retention of the periodic covenant tests represents, in substance, a grace period. If viewed as a grace period, the borrower would classify the debt as current (see paragraph 470-10-45-11) unless it is probable that the borrower can cure the violation (comply with the covenant) within the grace period. Specifically, the balance sheet classification of an obligation is considered in the following situations:

- a. The debt covenants are applicable only after the balance sheet date, and it is probable that the borrower will fail to meet the covenant requirement at the compliance date three months after the balance sheet date.
- b. The borrower meets the current covenant requirement at the balance sheet date, and it is probable that the borrower will fail to meet the same covenant requirement at the compliance date in three months.

- c. The borrower meets the current covenant requirement, and it is probable that the borrower will fail to meet a more restrictive covenant requirement applicable at the compliance date in three months.
- d. The borrower has met the covenant requirement in the prior quarter but before the balance sheet date negotiates a modification of the loan agreement that eliminates the covenant requirement at the balance sheet date or modifies the requirement so that the borrower will comply. Absent the modification, the borrower would have been in violation of the covenant at the balance sheet date. The same or a more restrictive covenant must be met at the compliance date in three months, and it is probable that the borrower will fail to meet that requirement at that subsequent date.
- e. The borrower is in violation of the current covenant requirement at the balance sheet date and, after the balance sheet date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), obtains a waiver. The same or a more restrictive covenant must be met at the compliance date in three months, and it is probable that the borrower will fail to meet that requirement at that subsequent date.

55-5 In the situations described in (a) through (c) of the preceding paragraph, the debt would be classified as noncurrent, in which case the borrower would be required to disclose the adverse consequences of its probable failure to satisfy future covenants.

55-6 In the situations described in paragraph 470-10-55-4(d) through (e), the debt would be classified as current. However, if the debt is expected to be refinanced on a long-term basis and the borrower meets the provisions of paragraphs 470-10-45-13 through 45-20, the debt would be classified as noncurrent.

The above FASB example illustrates the classification of long-term debt when the creditor waives a covenant violation for a period greater than a year.

The examples that follow illustrate additional scenarios involving covenant violations. The following table summarizes the differences in fact pattern for easier navigation.

Example	Description
3.6.50	<ul style="list-style-type: none"> — Debtor has no covenant requirement at reporting date — Debtor noncompliance in a future period is probable
3.6.60	<ul style="list-style-type: none"> — Debtor is in compliance at reporting date — Debtor noncompliance in a future period is probable
3.6.70	<ul style="list-style-type: none"> — Debtor modified debt before reporting date in anticipation of noncompliance — Debtor noncompliance in a future period is probable
3.6.80	<ul style="list-style-type: none"> — Debtor obtains waiver for violation at reporting date — Debtor noncompliance in a future period (same covenant as waived) is probable

Example	Description
3.6.90	<ul style="list-style-type: none"> — Debtor obtains waiver for violation at reporting date — Debtor noncompliance in a future period (covenant different from that waived) is probable
3.6.100	<ul style="list-style-type: none"> — Debtor obtains waiver for violation at reporting date — Debtor is not probable of noncompliance in a future period
3.6.110	<ul style="list-style-type: none"> — Debtor defaults at reporting date, but cures violation during contractual grace period — Debtor noncompliance in a future period is not probable
3.6.120	<ul style="list-style-type: none"> — Debtor is in compliance at reporting date — Debtor is noncompliant after reporting date, but before financial statements are issued
3.6.130	<ul style="list-style-type: none"> — Debtor is noncompliant at reporting date — Debtor did not obtain waiver, cure violation or refinance on a long-term basis
3.6.140	<ul style="list-style-type: none"> — Debtor has senior and subordinated debt with cross-default provision — Debtor is noncompliant on subordinated debt at reporting date and obtains 90-day waiver — Creditor of senior debt can demand payment because of cross-default provision
3.6.150	<ul style="list-style-type: none"> — Debtor identifies nonfinancial covenant violation after reporting date, but before financial statements are issued, which relates to reporting date



Example 3.6.50

Debt covenants applicable for measurement dates occurring after the reporting date; future noncompliance is probable

On October 1, Year 4, Debtor, an SEC registrant, obtains a three-year loan from Bank. A provision in the agreement requires Debtor to maintain a minimum level of working capital at the end of each quarter in Years 5, 6 and 7.

Bank has the right to demand immediate payment if Debtor fails to comply with the loan covenant. There are no other provisions that allow Bank to demand payment before the stated maturity date, including any subjective acceleration clause.

The first date on which compliance must be determined is March 31, Year 5. At December 31, Year 4, based on management's forecast, Debtor concludes it is probable that it will not meet the minimum working capital requirement at the March 31, Year 5 measurement date.

Debtor classifies the term loan as a noncurrent liability in its December 31, Year 4 financial statements. This is appropriate despite the future probable covenant violation because:

- the debt is long-term based on its terms; and
- Debtor is not required to comply with the working capital covenant as of December 31, Year 4.

Debtor should disclose the potential adverse and legal consequences of its probable failure to comply with the covenant in Year 5 in the notes to its Year 4 financial statements. Debtor must include a discussion of the consequences of the probable covenant violation in MD&A (see section 3.8).



Example 3.6.60

Debtor in compliance with covenant at reporting date; future noncompliance is probable

On October 1, Year 4, Debtor, an SEC registrant, obtains a three-year loan from Bank. The provisions of the agreement require Debtor to maintain a minimum of:

- \$5 million of working capital as of December 31, Year 4; and
- \$7 million of working capital as of March 31, Year 5 and at the end of each quarter thereafter.

Bank has the right to demand immediate payment if Debtor fails to comply with the loan covenant. There are no other provisions that allow Bank to demand payment before the stated maturity date, including any subjective acceleration clause.

Debtor is in compliance with the minimum working capital requirement as of December 31, Year 4. However, based on management's forecast, Debtor concludes it is probable it will not meet the minimum working capital requirement at the March 31, Year 5 measurement date.

Debtor classifies the term loan as a noncurrent liability in its December 31, Year 4 financial statements. This is appropriate despite the probable covenant violation because:

- the debt is long-term based on its terms; and
- Debtor is in compliance with the provisions of the debt agreement as of the reporting date.

Debtor should disclose the adverse consequences of its probable failure to comply with the covenant in Year 5 in the notes to its Year 4 financial statements. Debtor must include a discussion of the consequences of the probable covenant violation in MD&A (see section 3.8).



Example 3.6.70

Debt modified before reporting date in anticipation of a covenant violation; future noncompliance is probable

On July 1, Year 4, Debtor, an SEC registrant, obtains a three-year loan from Bank. The agreement requires Debtor to maintain a minimum level of working

capital as of the end of each quarter beginning with September 30, Year 4. Bank has the right to demand immediate payment if Debtor fails to comply with the loan covenant. There are no other provisions that allow Bank to demand payment before the stated maturity date, including any subjective acceleration clause.

Debtor complies with the minimum working capital requirement as of September 30, Year 4. Due to the loss of a major customer in late November Year 4, Debtor determines it is probable that it will be unable to comply with the working capital covenant at each of the next two compliance dates (December 31, Year 4 and March 31, Year 5).

On December 15, Year 4, Debtor and Bank modify the debt agreement to eliminate the December 31, Year 4 measurement date for the covenant. The March 31, Year 5 measurement date and all future measurement dates remain unchanged. At December 31, Year 4, based on management's forecast, it is probable that Debtor will be unable to comply with provisions of the debt for each compliance period through December 31, Year 5.

Debtor classifies the term loan as a current liability in its December 31, Year 4 financial statements notwithstanding that there was no measurement date for the covenant as of December 31, Year 4. This is because:

- without the modification, Debtor would be in violation of its covenant at the December 31, Year 4 reporting date; and
- it is probable Debtor will be unable to comply with all provisions of the debt agreement for a period of one year from the reporting date.

Debtor should disclose the adverse consequences of its probable failure to comply with the covenant in Year 5 in the notes to its Year 4 financial statements. Debtor must include a discussion in MD&A (see section 3.8).



Example 3.6.80

Violation at the reporting date is waived; future violation of the same covenant is probable

On October 1, Year 4, Debtor, an SEC registrant, obtains a three-year loan from Bank. One of the provisions of the agreement requires Debtor to maintain a minimum level of working capital as of the end of each quarter beginning with the quarter ended December 31, Year 4.

Bank has the right to demand immediate payment if Debtor fails to comply with the loan covenant. There are no other provisions that allow Bank to demand payment before the stated maturity date, including any subjective acceleration clause.

Debtor fails to comply with the minimum working capital requirement as of December 31, Year 4. However, Bank provides a waiver permanently relinquishing its right to demand payment as a result of the December 31, Year 4 violation. Based on management's forecast, it is probable that Debtor will be unable to comply with the covenant at the next compliance date (March 31, Year 5).

Debtor classifies the loan as a current liability in its December 31, Year 4 financial statements notwithstanding that Bank has permanently waived its right to demand repayment of the loan due to that violation. This is because:

- without the waiver, Debtor would be in violation of its covenant at the December 31, Year 4 reporting date; and
- it is probable Debtor will be unable to comply with all provisions of the debt agreement for a period of one year from the reporting date.

Because Debtor is an SEC registrant, it is required to disclose the covenant violation, the related waiver (including the period of the waiver), and the amount of the borrowings affected in its December 31, Year 4 financial statements.

Further, Debtor is required to disclose the adverse consequences of its probable failure to comply with the covenant in Year 5 in the notes to its Year 4 financial statements. Debtor also must include a discussion in MD&A (see section 3.8).



Example 3.6.90

Violation at the reporting date is waived for more than one year; future violation of a different covenant is probable

On October 1, Year 4, Debtor, an SEC registrant, obtains a three-year loan from Bank. The agreement includes two covenants: Debtor must (1) maintain a minimum level of working capital and (2) keep its debt-to-equity ratio below a specified level.

Bank has the right to demand immediate payment if Debtor fails to comply with either covenant. There are no other provisions that allow Bank to demand payment before the stated maturity date, including any subjective acceleration clause.

Debtor measures compliance with both covenants as of the end of each quarter beginning with the quarter ended December 31, Year 4. Debtor is in compliance with the debt-to-equity covenant as of December 31, Year 4; however, it fails to comply with the minimum working capital requirement. Bank provides a waiver permanently relinquishing its right to demand repayment of the debt as a result of the December 31, Year 4 violation of the working capital covenant or any future violation of the working capital covenant through January 1, Year 6. Based on management's current forecast, it is probable that Debtor will violate the debt-to-equity covenant at the next compliance date (March 31, Year 5).

Debtor classifies the loan as a current liability in its December 31, Year 4 financial statements notwithstanding that Bank has permanently waived its right to demand repayment of the loan due to the violation of the minimum working capital covenant. This is because:

- without the waiver, Debtor would be in violation of a covenant at the December 31, Year 4 reporting date; and
- it is probable Debtor will be unable to comply with all of the provisions of the debt agreement for a period of one year from the reporting date.

Because Debtor is an SEC registrant, it is required to disclose the covenant violation, the related waiver (including the period of the waiver), and the amount of the borrowings affected in its December 31, Year 4 financial statements.

Further, Debtor is required to disclose the adverse consequences of its probable failure to comply with the debt-to-equity covenant in Year 5 in the notes to its Year 4 financial statements. Debtor must include a discussion of the consequences of the probable covenant violation in MD&A (see section 3.8).



Example 3.6.100

Violation at the reporting date is waived; future compliance is probable

Debtor, an SEC registrant, has a loan with Bank. The terms of the loan agreement require Debtor to maintain a minimum level of working capital on December 31 of each year. Bank has the right to demand immediate payment if Debtor fails to comply with the loan covenant. There are no other provisions that allow Bank to demand payment before the stated maturity date, including any subjective acceleration clause.

On December 31, Year 4, Debtor fails to comply with the requirement to maintain a minimum level of working capital. On January 14, Year 5, Bank waives its rights regarding the covenant violation as of December 31, Year 4, including its ability to call the loan for one year after the reporting date because of the violation. Based on management's forecast, it is probable that Debtor will be in compliance with the minimum working capital covenant (and all other provisions of the debt agreement) on the next measurement date, December 31, Year 5.

Debtor classifies the loan as a noncurrent liability in its December 31, Year 4 financial statements because:

- it obtained a waiver for the December 31, Year 4 covenant violation and that waiver does not allow Bank to require repayment of the loan within one year of the reporting date; and
- it is not probable that Debtor will violate any provisions of the debt agreement for a period of one year from the reporting date.

Because Debtor is an SEC registrant, it is required to disclose the covenant violation, the related waiver (including the period of the waiver), and the amount of the borrowings affected in its December 31, Year 4 financial statements. Further, Debtor should consider whether a discussion and analysis is necessary in MD&A (see section 3.8).



Example 3.6.110

Violation at the reporting date; debtor has right to cure

On October 1, Year 4, Debtor obtains a three-year loan from Bank. One of the terms of the agreement requires Debtor to submit monthly financial statements to Bank within 31 days of month-end.

The agreement provides a five-day grace period for Debtor to comply with the requirement, and Debtor may use the grace period for up to three occasions each year. If Debtor submits the financial statements within the five-day grace period, the violation is cured, and Bank is not permitted to demand payment. Bank has the right to demand immediate payment if Debtor fails to comply with this requirement. There are no other provisions that allow Bank to demand payment before the stated maturity date, including any subjective acceleration clause.

Debtor fails to submit its November 30, Year 4 financial statements to Bank by the December 31, Year 4 deadline. However, Debtor cures the default within the five-day grace period and determines it is not probable that it will violate this requirement, or any other provisions of the debt agreement, during the one year subsequent to the December 31, Year 4 reporting date.

Debtor classifies the term loan as a noncurrent liability in its December 31, Year 4 financial statements because:

- Debtor cures the default within the grace period and Bank therefore is not able to call the loan; and
- it is not probable Debtor will violate any provisions of the debt agreement for a period of one year from the reporting date.

Debtor should disclose the violation and the fact that the violation was cured within the grace period (see section 3.8).



Example 3.6.120

Compliance at the reporting date; violation occurs before issuance of the financial statements

On October 1, Year 4, Debtor, an SEC registrant, obtains a three-year loan from Bank. One of the agreement's terms requires Debtor to maintain a minimum level of working capital as of the end of each month beginning on November 30, Year 4.

Bank has the right to demand immediate payment if Debtor fails to comply with the loan covenant. There are no other provisions that allow Bank to demand payment before the stated maturity date, including any subjective acceleration clause.

Debtor is in compliance with the minimum working capital requirement as of November 30, Year 4 and December 31, Year 4. However, Debtor does not comply with the covenant on January 31, Year 5. Consequently, Bank has the

right to demand immediate payment, but it does not demand payment through the date on which Debtor issues its December 31, Year 4 financial statements.

Debtor classifies the loan as a noncurrent liability in its December 31, Year 4 financial statements. Noncurrent classification of the debt is appropriate despite the covenant violation because:

- the debt was long-term as of December 31, Year 4 based on its terms; and
- Debtor was in compliance with provisions of the debt agreement as of the December 31, Year 4 reporting date.

Debtor should disclose in a subsequent events note to its Year 4 financial statements its failure to comply with the covenant subsequent to the reporting date, the provision in violation, and that Bank has not exercised its right to demand payment. Debtor should also disclose other adverse or legal consequences of its failure to comply with the covenant after December 31, Year 4. Debtor should also consider including a discussion in MD&A (see section 3.8).



Example 3.6.130

Debtor is in violation at year-end and delays issuing its financial statements

Debtor, a non-SEC registrant, is in violation of its loan covenants as of December 31, Year 4. The creditor does not demand repayment during Year 5, and Debtor delays issuing its Year 4 financial statements until March 31, Year 6.

Debtor classifies the debt as a current liability in its December 31, Year 4 financial statements because:

- the creditor had the ability to call the debt during the one-year period following the reporting date of December 31, Year 4; and
- Debtor did not obtain a waiver, cure the violation, or refinance the debt on a long-term basis.

The classification is appropriate even though the creditor did not exercise its right to demand repayment within one year of the December 31, Year 4 reporting date.



Example 3.6.140

Multiple debt instruments with cross-default provisions

Debtor has a senior debt instrument and a subordinated debt instrument. The senior debt includes a cross-default provision to the subordinated debt so a default in the subordinated debt is a default for the senior debt.

Both the senior debt and the subordinated debt agreements allow the respective creditors to demand immediate payment on a covenant violation. There are no other provisions that allow the creditors to demand payment before the stated maturity date, including any subjective acceleration clause.

On December 31, Year 4, Debtor violates a covenant of the subordinated debt instrument. However, the subordinated debt creditor grants a 90-day waiver and has not demanded payment.

In its December 31, Year 4 financial statements, Debtor classifies the debt instruments as follows.

- **Subordinated debt.** Classified as a current liability because Debtor has received a waiver for only 90 days. For the debt to be classified as a noncurrent liability:
 - the covenant violation must be waived for a continuous period of more than one year following the reporting date; and
 - it must not be probable that Debtor will violate any provisions of the subordinated debt instrument at measurement dates that are within one year following the reporting date; and
- **Senior debt.** Classified as a current liability because the cross-default provision with the subordinated debt results in a covenant violation for the senior debt as of December 31, Year 4, which allows the creditor to demand payment. Debtor classifies the senior debt as a current liability because the waiver by the subordinated debt lender does not waive the violation of the covenant under the senior debt agreement. Therefore, the senior debt lender may still call its loan.

Debtor should disclose the violation of the subordinated debt, the related waiver (including the period of the waiver) and the cross-default provision which allows the creditor of the senior debt to call the loan (see section 3.8).



Example 3.6.150

Classification of debt with a violation of nonfinancial covenant after the reporting date

Debtor has outstanding borrowings with Bank as of December 31, Year 8. The terms of the debt agreement include a nonfinancial restrictive covenant that is violated if Debtor receives an audit report on its annual financial statements that contains a going concern modification. There are also financial covenants that are required to be met each quarter, but no subjective acceleration clauses in the terms of the agreement.

As of December 31, Year 8, Debtor is experiencing financial difficulties. Although it has not violated its financial covenants for the period, there is substantial doubt about its ability to continue as a going concern within one year from the date the financial statements are issued. In March Year 9, Debtor's auditors communicate that Debtor will receive an audit report with an emphasis-of-matter paragraph related to significant doubt about its ability to continue as a going concern.

Because Debtor is in violation of the nonfinancial covenant pertaining to its audit report, it considers the effect on the classification of the related debt as of December 31, Year 8. Although the covenant violation technically occurred after the reporting date, the violation directly pertains to the period ended

December 31, Year 8 because the audit report is based on the financial condition and results as of and for the year ended on the reporting date.

Therefore, because Debtor did not receive a waiver for the violation from Bank, Debtor classifies the debt as current as of December 31, Year 8.

Debtor should disclose the violation that allows Bank to call the debt on demand (see section 3.8).

3.6.50 Transactions after the reporting date

A debtor assesses all subsequent events or transactions that occur after its reporting date but before the financial statements are issued (available to be issued) for any impact to the classification of debt as well as for any required disclosures. The impact of subsequent events on debt classification depends on consideration of specific facts and circumstances.



Example 3.6.160

Long-term callable debt when debtor exercises call option after the reporting date

Debtor has debt outstanding that it has the right to repay before the stated maturity dates. At the reporting date, the contractual maturity of the debt extends beyond one year. Debtor does not intend to repay the debt ahead of maturity, and there are no other circumstances that indicate the debt should be classified as a current liability (e.g. no covenant violations).

After year-end, Debtor's management recommends, and the board of directors approves, the redemption of the outstanding debt.

Contractually long-term callable debt remains classified as noncurrent if the debtor decides after the reporting date but before the issuance of the financial statements to exercise its call option and repay the obligation.

In this example, the decision to redeem callable debt after year-end is a nonrecognized subsequent event under Topic 855 because management had not reached a decision as of the reporting date. However, a subsequent event disclosure describing the redemption is required to prevent the financial statements from being misleading.

The impact of subsequent events on debt classification depends on consideration of specific facts and circumstances – e.g. consideration should be given to management/board decisions reached shortly after the reporting date as to whether there was intent to repay the debt at the reporting date.

Note: If Debtor's board had approved early redemption, and Debtor had announced exercise of the call option just before the reporting date, it would be legally obligated to redeem the debt obligation within one year of the reporting date. Therefore, the debt would have been classified as current at the reporting date.



Example 3.6.170

Debt that has a provision to be repaid when assets are sold after the reporting date

Scenario 1: No intent at year-end to dispose of assets

On December 31, Year 3, Debtor has \$1 million of outstanding debt with a stated maturity date of January 1, Year 6. The terms of the debt instrument require repayment before the stated maturity date if Debtor:

- disposes of certain specified assets that collateralize the debt; and
- receives proceeds in excess of \$1 million from the sale of those assets.

Debtor is in compliance with all covenants as of December 31, Year 3, and there are no other provisions that could require repayment before the stated maturity date.

As of December 31, Year 3, Debtor has no intention of disposing of any of the specified assets and is undertaking no activities indicating it will sell the assets within one year. Therefore, it properly classifies the assets as noncurrent in the December 31, Year 3 balance sheet. Further, Debtor has no intention at December 31, Year 3 of repaying the debt before the stated maturity date.

Subsequent event

In February, Year 4, before the issuance of its Year 3 financial statements, Debtor decides to sell a portion of the specified assets and receives proceeds in excess of \$1 million. Therefore, it is required to repay the \$1 million of outstanding borrowings in February, Year 4.

The decision to sell the assets (thereby triggering repayment of the debt) after year-end is a nonrecognized subsequent event under Topic 855 because Debtor had not reached a decision to sell the assets as of the reporting date. A post-balance sheet event requiring the repayment of the loan does not require classification of the debt as a current liability at the reporting date – even if the event occurs before issuance of the financial statements.

Debtor does not classify the debt as a current liability at the December 31, Year 3 reporting date because the debt has a stated maturity date beyond one year, and the event that triggers its repayment occurs after the reporting date.

Debtor discloses the post-balance sheet sale of the assets and the repayment of the debt as a subsequent event in the notes to its Year 3 financial statements.

Scenario 2: Intent at year-end to dispose of assets

At December 31, Year 3, management intends to dispose of the specified assets within one year of the reporting date and expects to receive proceeds in excess of \$1 million. Further, the specified assets (disposal group) meet the criteria to be classified as held-for-sale as of December 31, Year 3; see section 4.2 of KPMG Handbook, [Discontinued operations & HFS disposal groups](#).

If a debt obligation must be repaid upon the sale of held-for-sale assets classified as current assets, the debt generally should be classified as a current liability.

 **Question 3.6.200**
How does an excess cash flow provision payment affect debt classification?

Background: The purpose of an excess cash flow provision in a debt agreement is to require the debtor to apply excess cash flow (or some percentage of excess cash flow) to reduce the outstanding debt balance. An excess cash flow provision may require a yearly or quarterly calculation and payment.

The excess cash flow calculation is defined in the debt agreement and typically is objectively determinable. Any payment due under the excess cash flow provision reduces the principal amount outstanding under the debt agreement (and is typically due within a three-month period from the required calculation date). However, this payment is in addition to any other scheduled principal and interest payments required under the agreement.

Interpretive response: An excess cash flow provision in a debt agreement may affect the debt’s classification if a payment is triggered as of the reporting date or within one year of the reporting date. In our experience, there are two approaches in practice with respect to the debt’s classification.

Approach A	Approach B
<p>An expected excess cash flow payment, payable within one year is considered a current liability.</p>	<p>An excess cash flow provision is considered a point-in-time covenant, for which a debtor should assess the appropriate classification taking into consideration whether the debtor can cure the violation of the covenant by making the required payment.</p>
<p>The term ‘current liabilities’ “...is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.” [Master Glossary]</p> <p>Topic 210 states, “The concept of current liabilities includes estimated or accrued amounts that are expected to be required to cover expenditures within the year for known obligations the amount of which can be determined only approximately...”</p> <p>These concepts imply a debtor should analyze cash flow forecasts to determine if excess cash flow provision payments will be required during the next 12 months. [210-10-45-6]</p> <p>Therefore, the debtor classifies all excess cash flow payments that are reasonably expected to be made</p>	<p>The debtor should classify the entire amount of an obligation as noncurrent, unless: [470-10-45-1]</p> <ul style="list-style-type: none"> — a covenant violation that gives the creditor the right to call the debt has occurred at the reporting date (or would have occurred absent a loan modification); and — it is probable that the debtor will not be able to cure the default (comply with the covenant) at measurement dates that are within the next year. <p>If at the reporting date the excess cash flow provision has been triggered, and therefore a covenant violation has occurred for that reporting date, the first condition is met.</p> <p>In assessing the second condition, the debtor considers the current violation (V-current) and potential future violations (V-future) for one year after the reporting date.</p> <p>If it is probable that the debtor will not be able to cure V-current or V-future, the second condition is met – i.e. it is probable</p>

Approach A	Approach B
<p>within one year following the reporting date as a current liability.</p> <p>In estimating all excess cash flow payments to be reported as a current liability, the debtor:</p> <ul style="list-style-type: none"> — determines whether an amount is currently payable (due within one year of the reporting date) based on the reporting date excess cash flow calculation; and — estimates other amounts that are reasonably expected to be paid within one year of the reporting date using the excess cash flow calculation for those future periods. <p>When estimating future excess cash flow provision payments, the debtor should use current forecasts and other information used to support other financial statement assertions – e.g. cash flow projections used for its budgeting, impairment of long-lived assets, and goodwill or tax valuation analyses.</p> <p>The debtor continues to update those estimates at subsequent reporting dates.</p>	<p>that the debtor would not cure the covenant violation at measurement dates within the next year. Therefore, the entire amount of the debt would be classified as current.</p> <p>However, if it is probable that the debtor will be able to cure V-current and V-future, only the amount due under the current period calculation would be classified as current. The remaining amount would be classified as noncurrent.</p> <p>Under Approach B, the debtor applies the guidance of paragraph 470-10-45-1 only if the excess cash flow provision is actually triggered for that reporting date calculation. Unlike Approach A, calculations for future measurement dates are not considered.</p>

Given the diversity in practice, we believe both views are acceptable. Therefore, a debtor should make an accounting policy election and apply it consistently with appropriate disclosures.



Example 3.6.180

Excess cash flow provision – annual determination

Debtor issues a debt instrument on January 1, Year 2 that requires a lump-sum repayment of \$10 million at the end of its seven-year contractual term.

The debt instrument includes an excess cash flow provision that requires Debtor to make a mandatory prepayment of the debt instrument equal to 75% of its excess cash flows at the end of each calendar year. The agreement defines excess cash flow as the amount of cash flow Debtor generates from operations after it has paid dividends and other capital expenditures.

The measurement date each year for the excess cash flow test is December 31. The payment date for any amount due is February 14 of the year following the measurement date – i.e. February 14, Year 3 for the measurement date December 31, Year 2.

As of December 31, Year 2, Debtor does not meet the excess cash flow threshold established in the debt agreement. However, at that date Debtor estimates it will have excess cash flows throughout Years 3 and 4. Specifically, it estimates that at December 31, Year 3 and Year 4 it will meet the excess cash flow provision and payments of \$1 million and \$2 million will be due on February 14, Year 4 and February 14, Year 5, respectively.

Classification of debt at December 31, Year 2

Under either of the approaches discussed in Question 3.6.200, Debtor does not classify any portion of the debt as current at December 31, Year 2.

If Debtor applies **Approach A**, at the December 31, Year 2 reporting date it does not classify any portion of the debt as current because:

- no amount is currently payable at the reporting date based on the December 31, Year 2 excess cash flow calculation; and
- no amounts are reasonably expected to be paid within one year of the current reporting date (December 31, Year 2) using the excess cash flow calculation for December 31, Year 3 – i.e. the payment estimated for the December 31, Year 3 period-end will not be paid until February 14, Year 4, which is beyond one year of the current reporting date.

If Debtor applies **Approach B**, at the December 31, Year 2 reporting date it does not classify any portion of the debt as current because the current reporting date's excess cash flow provision has not been triggered.

Classification of debt in interim periods in Year 3

Assume the estimated payments of \$1 million and \$2 million on February 14, Year 4 and February 14, Year 5, respectively, continue to be reasonably expected based on updated estimates at each respective reporting date.

Whether Debtor should classify any portion of the debt as current in its interim financial statements at March 31, June 30 or September 30, Year 3 depends on the view it applies.

If Debtor applies **Approach A**, at each interim reporting date in Year 3 it classifies \$1 million of the debt as current because:

- no amount is currently payable at each reporting date based on the respective reporting date excess cash flow calculation – i.e. this is an annual calculation, so no amounts are calculated quarterly; and
- \$1 million is reasonably expected to be paid over the next year – i.e. the payment estimated for the December 31, Year 3 reporting date will be paid on February 15, Year 4, which is within a year of each of the respective interim reporting dates in Year 3.

Because the estimated payment of \$2 million related to the projected excess cash flow calculation for December 31, Year 4 will not be paid until February 14, Year 5, it is not included in the amount classified as current. This is because that payment date extends beyond the one-year period for each of the reporting dates.

If Debtor applies **Approach B**, at each interim reporting date it does not classify any portion of the debt as current because the excess cash flow provision has not been triggered at the respective period-end. This is because the excess

cash flow provision is only required to be calculated at year-end and therefore no calculation is required and no payment is due during any interim period.

Classification of debt at December 31, Year 3

The estimated payments of \$1 million on February 14, Year 4 and \$2 million on February 14, Year 5 continue to be reasonably expected based on updated estimates at December 31, Year 3. Under both Approach A and Approach B, Debtor classifies \$1 million of the debt as current at December 31, Year 3.

If Debtor applies **Approach A**, at the December 31, Year 3 reporting date it classifies \$1 million of the debt as current because:

- \$1 million is currently payable at the reporting date based on the current period-end excess cash flow calculation; and
- no amounts are reasonably expected to be paid within one year of the current reporting date (December 31, Year 3) using the excess cash flow calculation for December 31, Year 4 – i.e. the payment estimated for the December 31, Year 4 reporting date will not be paid until February 14, Year 5, which is beyond one year from the current reporting date.

If Debtor applies **Approach B**, at the December 31, Year 3 reporting date it classifies \$1 million of the debt as current because the current reporting date's excess cash flow provision has been triggered and that amount is due within one year of period-end. Because it is probable that Debtor will be able to cure the default at measurement dates within the next year, the remaining debt is classified as noncurrent.



Example 3.6.190

Excess cash flow provision – quarterly determination

Debtor issues a debt instrument on January 1, Year 2 that requires a lump-sum repayment of \$10 million at the end its seven-year contractual term.

The debt instrument includes an excess cash flow provision that requires Debtor to make a mandatory prepayment of the debt instrument equal to 75% of its excess cash flows at the end of each calendar quarter. The agreement defines excess cash flow as the amount of cash flow Debtor generates from operations after it has paid dividends and other capital expenditures.

The measurement date each quarter for the excess cash flow test is the last day of the calendar quarter (i.e. March 31, June 30, September 30, December 31). The payment date for any amount due is the 45th day following the measurement date. For each reporting date, it is probable that Debtor will make any required payment by the payment date (i.e. within 45 days of the measurement date).

As of December 31, Year 2, Debtor does not meet the excess cash flow threshold established in the debt agreement. However, at December 31, Year 2, Debtor forecasts that it will meet the excess cash flow threshold for certain of the measurement periods as follows.

Reporting date	Excess cash flow payment date	Excess cash flow payment
Mar 31, Year 3	May 15, Year 3	\$250,000
June 30, Year 3	Aug 14, Year 3	\$100,000
Sept 30, Year 3	Nov 14, Year 3	-
Dec 31, Year 3	Feb 14, Year 4	\$650,000
Mar 31, Year 4	May 15, Year 4	\$300,000
June 30, Year 4	Aug 14, Year 4	\$200,000
Sept 30, Year 4	Nov 14, Year 4	-
Dec 31, Year 4	Feb 14, Year 5	\$500,000

Classification of debt at December 31, Year 2

Whether Debtor should classify any portion of the debt as current in the financial statements at December 31, Year 2 depends on the approach it applies (see Question 3.6.200).

If Debtor applies **Approach A**, at the December 31, Year 2 reporting date it classifies \$350,000 of the debt as current because:

- no amount is currently due at the reporting date based on the December 31, Year 2 excess cash flow calculation; and
- \$350,000 is reasonably expected to be paid within one year of the current period-end – i.e. the payments to be made on May 15 (\$250,000), August 14 (\$100,000) and November 14 (\$0). The payment estimated for the December 31, Year 3 period-end is not included because it will not be paid until February 14, Year 4, which is beyond one year from the current reporting date.

If Debtor applies **Approach B**, at the December 31, Year 2 reporting date it does not classify any portion of the debt as current because the current period-end excess cash flow provision has not been triggered.

Classification of debt at interim periods in Year 3

The payments continue to be reasonably expected at each date based on updated estimates at each respective period-end. The portion of the debt that Debtor should classify as current in its Year 3 interim financial statements depends on the approach it applies.

If Debtor applies **Approach A**, at each reporting date the amounts included in the total current liability column should be reported as current at each respective period-end.

Reporting date	Current excess cash flow due	Excess cash flow due in the next year	Total current liability
Mar 31, Year 3	\$250,000	\$ 750,000	\$1,000,000
June 30, Year 3	\$100,000	\$ 950,000	\$1,050,000
Sept 30, Year 3	-	\$1,150,000	\$1,150,000

If Debtor applies **Approach B**, it classifies \$250,000 at March 31, Year 3, and \$100,000 at June 30, Year 3 as current because the respective period-end excess cash flow provision has been triggered and those amounts are due within one year of the respective period-ends.

The second condition of whether it is probable that Debtor will not be able to cure the covenant violation (in paragraph 470-10-45-1(b)) is not met because it is probable that Debtor will pay:

- the current amount due under the respective current period calculation; and
- any amounts as and when due for future calculation periods within one year of period-end.

In this instance, it is probable that Debtor will cure any default at measurement dates within the next 12 months. Consequently, other than the current amount due under the current calculation period, no additional amounts are classified as current.

At September 30, Year 3, Debtor does not classify any portion of the debt as current because the excess cash flow provision has not been triggered at the period-end.

Classification of debt at December 31, Year 3

The payments continue to be reasonably expected at each date based on updated estimates at each respective period-end. The portion of the debt Debtor should classify as current in the financial statements at December 31, Year 3 depends on the approach it applies.

If Debtor applies Approach A, at December 31, Year 3 it classifies \$1,150,000 of the debt as current because:

- \$650,000 is currently payable at the reporting date based on the current period-end excess cash flow calculation; and
- \$500,000 is reasonably expected to be paid within one year of the current period-end – i.e. the payments to be made on May 15 (\$300,000), August 14 (\$200,000) and November 14, Year 4 (\$0). The payment estimated for the December 31, Year 4 period-end is not included because it will not be paid until February 14, Year 5, which is beyond one year from the current reporting date.

If Debtor applies **Approach B**, at December 31, Year 3 it classifies \$650,000 of the debt as current because the current period-end excess cash flow provision has been triggered and that amount is due within one year of period-end.

The second condition of whether it is probable that Debtor will not be able to cure the covenant violation (in paragraph 470-10-45-1(b)) would not be met because it is probable that Debtor will pay:

- the current amount due under the respective current period calculation; and
- any amounts due when and as due for future calculation periods within one year of period-end.

In this instance, it is probable that Debtor will cure any default at measurement dates within the next one year. Consequently, other than the current amount due under the current calculation period, no additional amounts are classified as current.

3.6.60 Classification of specific types of debt arrangements#

When determining the appropriate classification of convertible debt, increasing-rate debt and redeemable instruments subject to remarketing, a debtor considers the nature and timing of the expected settlement of the debt instrument.

Convertible debt

See section 10.9.20 for guidance about the balance sheet classification of convertible debt.

Increasing-rate debt



Excerpt from ASC 470-10

> Classification of Increasing-Rate Debt

45-7 Classification of increasing-rate debt as current or noncurrent would reflect the borrower's anticipated source of repayment that is, current assets or a new short-term debt borrowing versus a long-term refinancing agreement that meets the requirements of this Subtopic and need not be consistent with the time frame used to determine periodic interest cost.

45-8 If the debt is paid at par before its estimated maturity, any excess interest accrued shall be an adjustment of interest expense.

A debt agreement may include term-extending provisions, such that the maturity date of the debt extends at the option of the debtor or the creditor. Term extension options usually require an increase to the rate of interest at each extension – referred to as increasing-rate debt.

The classification of increasing-rate debt as current or noncurrent reflects the debtor's anticipated source of repayment (i.e. current assets versus long-term refinancing agreement) as discussed in this section, and need not be consistent with the timeframe used to determine periodic interest expense. [470-10-45-7]

For guidance on whether a term-extending feature warrants separate accounting as a derivative, see Question 9.3.250 and chapter 4 of KPMG Handbook, [Derivatives and hedging](#).



Example 3.6.200 Increasing-rate debt

On January 31, Year 1, Debtor entered into a \$10 million term loan with Bank, with an annual rate of interest of 6%, maturing on January 30, Year 4.

The terms of the agreement include a term-extension provision, and at January 30 Year 4, Debtor can elect to extend the term for another year, with a 100 bps increase in the interest rate. The term-extension provision can be elected up to

a maximum of three times, with the rate of interest increasing 100 bps upon each election of the term extension.

At December 31, Year 3, Debtor has the intent and ability to elect to extend the term and service the debt through January 30, Year 7 by the election of the maximum number of extension periods. Therefore, Debtor records the debt as noncurrent on the balance sheet at December 31, Year 3.

See Example 3.7.50 related to increasing-rate debt for an illustration of the recognition of interest expense, and the amortization of discounts and issuance costs, for increasing-rate debt.

Debt with a 'springing maturity' feature



Question 3.6.210

How does a debtor classify debt with a 'springing maturity' feature?

Background: Debt with a 'springing maturity' feature is debt with an initial maturity date that is automatically extended if certain contingencies are met on that date. Lenders may offer these features as better credit protection when, for example, the borrower's obligation under other debt outstanding is reduced. Similarly, these features may provide borrowers with flexibility to manage their liquidity and cash flows on a long-term basis.

Interpretive response: We believe the classification is based on the current active maturity date. The current active maturity date is the date that the debt will mature, assuming the contingencies are *not* met.

As a result, if the current active maturity date is within one year of the reporting date, the debt embodies a short-term obligation when evaluating the first step in the three-step process for classifying debt (see Question 3.6.10).

See also Question 3.4.110 about the period for amortizing debt premiums, discounts and debt issuance costs with a springing maturity feature.

Redeemable instruments subject to remarketing agreements#

Debt instruments may have remarketing features, where upon redemption or maturity, an agent will attempt to remarket the instrument on behalf of the debtor (issuer). The existence of such arrangements alone does not impact the debtor's classification of the debt as illustrated below in Subtopic 470-10's Example 2.



Excerpt from ASC 470-10

- > Example 2: Classification by the Issuer of Redeemable Instruments That Are Subject to Remarketing Agreements

55-7 This Example illustrates the guidance for the appropriate classification by the issuer of debt if all of the following conditions exist:

- a. The debt has a long-term maturity (for example, 30 to 40 years).
- b. The debt holder may redeem or put the bond on short notice (7 to 30 days).
- c. The issuer has a remarketing agreement that states that the agent will make its best effort to remarket the bond when redeemed.
- d. The debt is secured by a short-term letter of credit that provides protection to the debt holder in the event that the redeemed debt cannot be remarketed. (Amounts drawn against the letter of credit are payable back to the issuer of the letter of credit by the issuer of the redeemable debt instrument on the same day that the drawdown occurs.)

55-8 Debt agreements that allow a debt holder to redeem (or put) a debt instrument on demand (or within one year) should be classified as short-term liabilities despite the existence of a best-efforts remarketing agreement. That is, unless the issuer of the redeemable debt instrument has the ability and intent to refinance the debt on a long-term basis as provided for in paragraph 470-10-45-14, the debt should be classified as a current liability.

55-9 In this Example, the obligation would be classified by the issuer as noncurrent only if the letter-of-credit arrangement meets the requirements of paragraph 470-10-45-14(b).

Variable rate demand obligations (VRDOs), also called variable rate demand notes or variable rate demand bonds, are debt securities that:

- bear interest at a floating rate adjusted at specified intervals (such as daily, weekly, or monthly); and
- provide the investor with an option to put the bonds back to a remarketing agent whenever the interest rate changes.

VRDO's typically have legal maturities of at least 20 years, but historically have been marketed as liquid, short-term securities.

When VRDOs are put by an investor, a remarketing agent (a bank or other financial institution) is responsible for reselling them to new investors. If the remarketing agent is unable to remarket the VRDOs to another investor, the issuer (if self-liquid) or a liquidity provider (also a bank or another financial institution) is obligated to purchase those VRDOs from the investor.

Issuers of VRDOs typically obtain a liquidity facility from a financial institution to provide support for the funds needed to purchase the VRDOs from the investor if the investor exercises the put option in the VRDO and the remarketing agent is unable to find a purchaser for the VRDO.

Form of liquidity facility ¹	Support provided for the funds needed to purchase VRDOs
Letter of credit (LOC)	The financial institution typically guarantees the payment of principal and interest per the terms of the VRDO agreement and purchases the bonds if a VRDO remarketing process is not successful. The LOC is in place for a


Form of liquidity facility ¹	Support provided for the funds needed to purchase VRDOs
	specified period of time in accordance with the agreement
Standby bond purchase agreement (SBPA)	The financial institution only commits to purchase the bonds if a VRDO remarketing process is not successful but does not guarantee the payment of principal and interest. Under a SBPA, another financial institution typically provides a separate guarantee (bond insurance) of the payment of principal and interest per the terms of the VRDO agreement, or there is no such guarantee in place.
<p>Note:</p> <ol style="list-style-type: none"> LOCs and SBPAs typically contain covenants and terms allowing the financial institution to terminate the agreement if certain events occur. 	

LOCs and SBPAs have terms that may or may not cover the same period of time as covered by the terms of the VRDOs. If the term of the liquidity facility is less than the contractual term of the VRDOs, the issuer is generally required to:

- negotiate an extension of the LOC or SBPA;
- locate another financial institution to provide an LOC or SBPA; or
- call all of the outstanding VRDOs upon expiration of the liquidity facility.

Once drawn upon, liquidity facilities typically have payment terms that range from 30 days to five years after the date the VRDOs are purchased from the investors by the financial institution. These payment terms may be significantly shorter than the maturities of the VRDOs. The issuer’s indebtedness to the liquidity provider once a liquidity facility has been drawn upon is commonly referred to as a bank bond.

In the absence of a LOC or SBPA, the issuer is providing self-liquidity in relation to any VRDOs that are not successfully remarketed after being put by an investor. In that circumstance, the issuer would be required to repurchase those VRDOs from the investor.



Question 3.6.220**
How are VRDOs classified on an issuer’s balance sheet?

Interpretive response: It depends. Although VRDOs have legal maturities of least 20 years, the put feature at the option of the investor must be considered in determining the appropriate balance sheet classification. The existence of the best-efforts remarketing agreement does not impact the evaluation of whether a VRDO embodies a short-term debt obligation.

Short-term debt obligation classification

VRDOs the issuer could be required to redeem within one year of the balance sheet date are considered short-term debt obligations. Upon a failed remarketing, the issuer could be required to redeem a VRDO within one year of the balance sheet date if the VRDO can:

- be put back directly to the issuer within one year of the balance sheet date and is not supported by a liquidity facility (i.e. the issuer is self-liquid);
- only be put directly to the liquidity provider within one year of the balance sheet date; however, in the event of the non-performance or default by the liquidity provider, the issuer could be required to purchase the VRDO;
- only be put directly to the financial institution; however, the payment terms of the bank bonds in the liquidity facility are short-term;
- only be put directly to the financial institution and the contractual payment terms of the bank bonds in the liquidity facility are long-term; however, based on the issuer's evaluation of any subjective acceleration clause, the issuer concludes that the bank bonds should be treated as short-term obligations (e.g. it is considered probable that the creditor will invoke the subjective acceleration clause and accelerate repayment to a date within one year of the balance sheet date).

Long-term debt obligation classification

VRDOs are considered long-term debt obligations (excluding any principal payments that would be due within one year of the balance sheet date under the terms of the respective financing agreements (i.e. the VRDOs or the liquidity facility)) if all of the following conditions are met:

- there are no circumstances where the VRDOs can be put back directly to the issuer within one year of the balance sheet date (i.e. any redemption upon a failed remarketing is satisfied directly by the liquidity provider);
- in the event of non-performance or default by the liquidity provider, the issuer would not be required to redeem the VRDOs within one year of the balance sheet date;
- the payment terms of the bank bonds in the liquidity facility are long-term; and
- based on the issuer's evaluation of any subjective acceleration clause, the issuer concludes that the bank bonds embody long-term obligations.



Question 3.6.230**

How does an issuer account for the repurchase of VRDOs?

Interpretive response: When VRDOs are repurchased (redeemed) directly by the issuer, the transaction is accounted for by the issuer as a debt extinguishment even if the subsequent issuance of bank bonds is automatically triggered under the terms of the liquidity facility. The gain or loss on

extinguishment incorporates the writeoff of the portion of unamortized debt issuance costs associated with the redeemed VRDOs.

3.7 Accounting for specific types of debt arrangements

3.7.10 Indexed debt



Excerpt from ASC 470-10

> Indexed Debt

25-3 Debt instruments may be issued with both guaranteed and contingent payments. The contingent payments may be linked to the price of a specific commodity (for example, oil) or a specific index (for example, the S&P 500). In some instances, the investor's right to receive the contingent payment (an indexing feature) is separable from the debt instrument. If the indexing feature does not warrant separate accounting under Topic 815 or the instrument does not meet the definition of a derivative under Topic 815, the entire instrument shall be accounted for in accordance with paragraphs 470-10-25-4 and 470-10-35-4.

25-4 If the investor's right to receive the contingent payment is separable, the proceeds shall be allocated between the debt instrument and the investor's stated right to receive the contingent payment. The premium or discount on the debt resulting from the allocation shall be accounted for in accordance with Subtopic 835-30.

> Indexed Debt

35-4 As the applicable index value increases such that an issuer would be required to pay an investor a contingent payment at maturity, the issuer shall recognize a liability for the amount that the contingent payment exceeds the amount, if any, originally attributed to the contingent payment feature. The liability for the contingent payment feature shall be based on the applicable index value at the balance sheet date and shall not anticipate any future changes in the index value. When no proceeds are allocated originally to the contingent payment, the additional liability resulting from the fluctuating index value shall be accounted for as an adjustment of the carrying amount of the debt obligation.

Indexed debt is a type of debt structure that includes both stated payments (i.e. principal and interest) and contingent payments. Its returns are indexed to an underlying other than interest rates or the creditworthiness of the debtor. For example, the contingent payments may be linked to the price of a specific commodity (e.g. oil) or to a specific index (e.g. the S&P 500). [\[470-10-25-3\]](#)

The indexing feature (e.g. commodity-indexed or equity-indexed interest payments) makes indexed debt a hybrid financial instrument consisting of a

debt host contract and an embedded feature. The indexing feature is first evaluated under Topic 815 on initial measurement to determine if it represents an embedded derivative that is bifurcated and accounted for separately as a derivative. If the indexing feature is not bifurcated and accounted for separately as a derivative, the debtor applies the guidance in paragraph 470-10-35-4. [470-10-25-3]

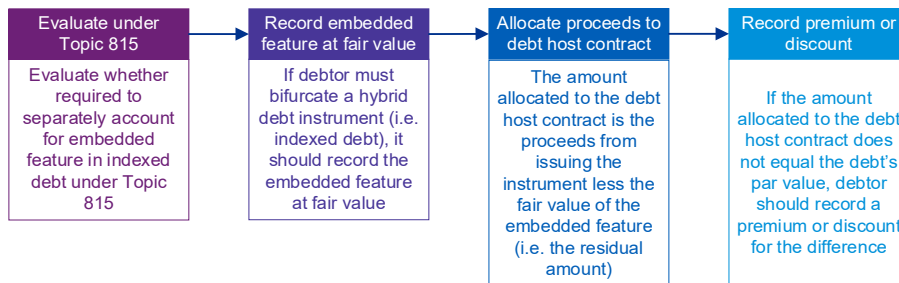
An example of indexed debt is the issuance of a bond with a \$1,000 par value, a periodic interest rate of 5% payable in cash, and a final payment that is the greater of:

- the \$1,000 par value; and
- an amount based on the S&P 500 index.

If the reference is to the fair value of owned real estate, for example, instead of the S&P 500 index, that debt structure is commonly called a participating mortgage (see section 3.7.20).

Question 3.7.10
How is an embedded feature in indexed debt analyzed and initially recognized?

Interpretive response: The following steps, which are discussed in depth in chapter 9, are relevant when evaluating whether the embedded feature in indexed debt is accounted for separately under Topic 815 and, if so, determining how to allocate the proceeds.



Bifurcation is required

As illustrated in the diagram, if a debtor must bifurcate a hybrid debt instrument (including indexed debt) under Topic 815, it records the embedded derivative at fair value and allocates the residual amount to the debt host contract – i.e. the proceeds from issuing the instrument less the fair value of the derivative. If the amount allocated to the debt host contract does not equal the debt's par value, the debtor records a premium or discount for the difference. [815-15-30-2]

Bifurcation is not required

Some indexed debt contracts may not qualify for separation under Topic 815 because they are indexed to a unique nonfinancial asset of one of the parties to the arrangement that is not readily convertible to cash.

For example, the scope exception in subparagraph 815-10-15-59(b) only applies when: [815-10-55-143]

- the nonfinancial asset is unique; and
- the nonfinancial asset is owned by the party that would not benefit under the contract from an increase in its price or value.

If the contingent payment does not require bifurcation, no proceeds are allocated to the feature. However, the debtor is required to account for subsequent changes in the index value (see Question 3.7.20).



Question 3.7.20

How is indexed debt subsequently measured?

Interpretive response: Subsequent to the initial recognition and measurement of the debt instrument and indexing feature, the index value may increase, requiring the debtor to make a contingent payment at maturity. The subsequent accounting for changes to the indexed value at the reporting date varies based on whether the indexing feature is bifurcated under Topic 815.

The following table outlines the accounting for an increase in the index value in each scenario. [470-10-35-4]

Indexing feature is bifurcated	Indexing feature is not bifurcated
If the indexing feature is required to be bifurcated under Topic 815, the indexing feature is subsequently measured at fair value with changes therein recognized in earnings; the accounting for the debt remains unchanged.	If the indexing feature is not required to be bifurcated under Topic 815, the additional liability resulting from the increase in the index value is accounted for as an adjustment to the net carrying amount of the debt instrument at the reporting date. ¹
<p>Note:</p> <p>1. Subtopic 470-10 does not specify whether increases in the index value should be recognized immediately in earnings or amortized over the remaining life of the debt. We believe it is appropriate to adjust the net carrying amount of the debt instrument for the increase in index value and amortize the adjusted discount over the remaining life of the instrument using the effective interest method.</p>	

3.7.20 Participating mortgage loans



Excerpt from ASC 470-30

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

30-1 If the lender is entitled to participate in appreciation in the **fair value** of the mortgaged real estate project, the borrower shall determine the fair value (see Subtopic 820-10) of the participation feature at the inception of the loan

(see paragraph 470-30-25-1 for guidance on how to recognize the participation feature).

In a participating mortgage loan, the creditor is entitled to participate in appreciation in the fair value of the mortgaged real estate project and/or the results of operations of the mortgaged real estate project. The debtor recognizes a participating liability and a corresponding discount on the mortgage loan. [470-30-25-1]

The liability is initially recognized at its fair value if: [470-30-25-1, 30-1]

- the participation right is based on the real estate's fair value; and
- the participating mortgage loan is not in the scope of Topic 815.



Question 3.7.30

Can a participating liability be a derivative under Topic 815?

Interpretive response: Yes. However, some participating mortgage loans may fall under a scope exception from derivative accounting because they are indexed to a unique nonfinancial asset of one of the parties to the arrangement that is not readily convertible to cash.

The scope exception applies to contracts that are not exchange traded if the underlying on which settlement is based is the price or value of a nonfinancial asset that is: [815-10-15-59(b)]

- unique and not readily convertible to cash; and
- owned by the party who would not benefit under the contract from an increase in its price or value.

The exception may apply if the creditor receives a below-market interest rate but is entitled to participate in the market value appreciation of the project when it is sold or at another specified date. In this case, settlement of the participating liability involves the price of a unique nonfinancial asset (a particular piece of real estate) of one of the parties to the contract that is not readily convertible to cash.

Further, the owner of the real estate does not benefit from the contract as the price of the underlying real estate increases. For additional discussion of this scope exception, see chapter 2 of KPMG Handbook, [Derivatives and hedging](#).



Question 3.7.40

If a participating liability feature is a derivative, how does a debtor account for a participating mortgage loan?

Interpretive response: How a participating liability feature is accounted for if it is a derivative depends on whether it is subject to one of the scope exceptions from derivative accounting in Topic 815 (see Question 3.7.30).

Scope exception does not apply

If a scope exception from derivative accounting does not apply, the participating liability can be accounted for:

- under Subtopic 470-30 (see Example 3.7.10); or
- under Topic 815 – i.e. accounted for separately as a derivative, similar to bifurcating an embedded derivative.

We believe the participation feature should generally be separately accounted for as a derivative under Topic 815 if the separation criteria in paragraph 815-15-25-1 are met.

Scope exception applies

When the scope exception from derivative accounting applies, we believe the debtor should account for a participating mortgage loan under the guidance in Subtopic 470-30.

Accounting for the participation feature under Topic 815 results in the entire change in fair value being recognized in earnings each period. This is in contrast to Subtopic 470-30, under which the change in fair value is recorded in the debt discount and amortized prospectively using the effective interest method. [470-30-35-4 – 35-5]

Accounting for a participating liability feature under Subtopic 470-30



Excerpt from ASC 470-30

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

35-2 Interest expense on participating mortgage loans consists of the following three components:

- Amounts designated in the mortgage agreement as interest
- Amounts related to the lender's participation in results of operations
- Amortization of debt discount related to the lender's participation in the **fair value** appreciation of the mortgaged real estate project.

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

35-4 Amounts due to a lender pursuant to the lender's participation in the real estate project's results of operations (as defined in the participating mortgage loan agreement) shall be charged to interest expense in the borrower's

corresponding financial reporting period, with a corresponding credit to the participation liability.

35-4A If a lender is entitled to participate in the appreciation of the market value of a mortgaged real estate project, both of the following are required at the end of each reporting period:

- a. The balance of the participation liability shall be adjusted to equal the current fair value of the participation feature.
- b. The corresponding debit or credit shall be recorded in the related debt-discount account.

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

40-1 If the participating mortgage loan is extinguished before its due date, the difference between the recorded amount of the debt (including the unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt is a debt extinguishment gain or loss.

45-1 The amortization of the debt discount relating to the participation liability shall be included in interest expense.

45-2 If the participating mortgage loan is extinguished before its due date, the debt extinguishment gain or loss shall be reported as required by paragraph 470-50-40-2.

Accounting for the participating liability feature under Subtopic 470-30 depends on the nature of the creditor's participation.

Participation in the market value appreciation of the mortgaged real estate. At the end of each reporting period, the balance of the participation liability is adjusted to the current fair value of the participation feature, with the corresponding entry to the related debt-discount account. The revised debt discount is amortized prospectively using the effective interest rate. [470-30-35-4A – 35-5]

Participation in real estate project's results of operations. Amounts due to the creditor (as defined in the loan agreement) are charged to interest expense in the borrower's corresponding financial reporting period, with a corresponding credit to the participation liability. [470-30-35-4]



Example 3.7.10

Participating mortgage loan borrower

This example is adapted from Example 1 in Subtopic 470-30. [470-30-55-1 – 55-5]

On January 1, Year 1, Debtor purchases property for \$15 million. On the purchase date, Debtor pays \$5 million cash and enters into a participating mortgage loan agreement with Bank in the amount of \$10 million.

The terms of the agreement are:

- 15-year term;
- 5% rate of interest;

- interest-only periodic payments, with principal balance to be repaid at the end of the 15-year term; and
- Bank’s participation in 20% appreciation of the value of the property above \$15 million payable at maturity, or earlier if the property is sold or refinanced.

The participation feature meets the scope exception from derivative accounting.

Debtor estimates the fair value of the participating feature at inception and at each reporting date. Debtor estimates its future payment related to the participation feature and the respective estimated fair value for each period as follows.

Period	Estimated value of property at end of term	Estimated payment (20% over \$15 million)	Present value of estimated payment ¹
January 1, Year 1	\$16,000,000	\$200,000	\$ 96,203
December 31, Year 1	\$16,500,000	\$300,000	\$151,520
December 31, Year 2	\$17,000,000	\$400,000	\$212,129

Note:

1. Based on 5% interest and the remaining term.

Debtor records the following journal entries on January 1, Year 1.

	Debit	Credit
Cash	10,000,000	
Mortgage loan payable – loan discount ¹	96,203	
Mortgage loan payable		10,000,000
Participating mortgage liability ¹		96,203
<i>To recognize participating mortgage arrangement.</i>		
Property – real estate	15,000,000	
Cash		15,000,000
<i>To recognize purchase of property.</i>		

Note:

1. The fair value of Bank’s participation in the mortgage is recorded as a discount to the loan, with a corresponding credit to the participation liability account. Fair value is calculated based on participation payment estimate as of January 1, Year 1.

Debtor records the following journal entries on December 31, Year 1.

	<i>Debit</i>	<i>Credit</i>
Interest expense ¹	504,427	
Interest payable		500,000
Mortgage loan payable – loan discount ²		4,427
<i>To recognize interest expense and amortization of loan discount.</i>		
Mortgage loan payable – loan discount ³	55,317	
Participating mortgage liability		55,317
<i>To adjust participating mortgage liability due to change in estimate of future payments.</i>		
Notes:		
1. 5% annual interest on principal balance of \$10 million plus the amortization of the loan discount of \$4,427.		
2. Using an effective interest rate of 5.093%, the discount of \$96,203 is amortized annually over the term of the agreement.		
3. Difference between estimated value on January 1, Year 1 (\$96,203) and value on December 31, Year 1 (\$151,520).		

Debtor records the following journal entries on December 31, Year 2.

	<i>Debit</i>	<i>Credit</i>
Interest expense ¹	507,427	
Interest payable		500,000
Mortgage loan payable - loan discount ²		7,427
<i>To recognize interest expense and amortization of loan discount.</i>		
Mortgage loan payable – loan discount ³	60,609	
Participating mortgage liability		60,609
<i>To recognize change in value of participating mortgage liability.</i>		
Notes:		
1. Because of the increase in the loan discount at December 31, Year 1, Debtor calculates a new effective interest rate of 5.15%. Interest expense represents the 5.15% effective interest rate applied to the carrying amount of the debt: principal (\$10 million) – adjusted discount (\$147,093) = \$9,852,907.		
2. Using the new effective interest rate, the new unamortized discount balance of \$147,093 (\$96,203 - \$4,427 + \$55,317) is amortized annually over the remaining term of the agreement.		
3. Difference between estimated value on December 31, Year 1 (\$151,520) and value on December 31, Year 2 (\$212,129).		

Note: If Bank participates in the results of operations of the mortgaged property (instead of in market value appreciation), Debtor will not record a participating liability at inception. Subsequently, any amount due to Bank relating to its

participation in the operating results of the mortgaged property is recorded as a participation liability and charged to interest expense in the period incurred.

3.7.30 Sales of future revenue



Excerpt from ASC 470-10

> Sales of Future Revenues or Various Other Measures of Income

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

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

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

> Sale of Future Revenues or Various Other Measures of Income

35-3 Amounts recorded as debt shall be amortized under the interest method (see Subtopic 835-30) and amounts recorded as deferred income shall be amortized under the **units-of-revenue method**.

A sale of future revenue typically occurs when an entity receives an upfront cash payment from a third party (the investor) in return for the entity paying the investor a specified percentage or amount of the entity's revenue or other measure of income for a defined period.

Although the feature provides some variability in returns to the investor (based on the entity's revenue or other measure of income), the feature generally meets a scope exception from derivative accounting – e.g. pursuant to paragraph 815-10-15-59 for certain contracts that are not traded on an exchange (see chapter 2 of KPMG Handbook, [Derivatives and hedging](#)).

When any of the following factors are present, there is a rebuttable presumption that the upfront payment an entity receives from the investor is debt instead of deferred income: [\[470-10-25-2\]](#)

- the form of the transaction is debt;
- the entity has significant continuing involvement in generation of the cash flows due to the investor;
- the transaction is cancelable by either party through payment of a lump sum or the transfer of assets;
- the investor's rate of return is capped, either explicitly or implicitly;
- variations in revenue or income from the transaction have an insignificant effect on the investor's rate of return; or
- the investor has recourse to the entity for payments due to the investor.



Question 3.7.50

How difficult is it to overcome a rebuttable presumption that an upfront payment is debt?

Interpretive response: The SEC staff has indicated that in many cases the factors related to significant continuing involvement (subparagraph 470-10-25-2(b)) and recourse (subparagraph 470-10-25-2(f)) are, when present, difficult to overcome. [\[1997 SEC Conf\]](#)

Based on our informal discussions with the SEC staff, we believe all of the factors in paragraph 470-10-25-2 should be strictly applied, and if any of the factors exist, the rebuttable presumption that the upfront cash payment is classified as debt is difficult to overcome. Therefore, careful evaluation is required if an entity believes that the upfront cash payment associated with a sale of future revenue should be classified as deferred income.



Example 3.7.20

Sales of future revenue

Pharma enters into a royalty monetization agreement with Investor to sell its royalty rights related to a specific drug compound for an upfront cash payment of \$25 million.

The agreement stipulates that Investor will receive the first \$50 million of royalty revenues received by Pharma related to the specific drug compound – i.e. the maximum amount that Investor will receive is \$50 million.

Because the \$50 million cap causes Investor's rate of return to be explicitly limited by the terms of the agreement, there is a rebuttable presumption that the \$25 million upfront payment is debt.

Pharma determines that it has sufficient and comprehensive support to conclude that there is only a remote probability the cap will be met. However, this does not overcome the rebuttable presumption that Pharma should classify the upfront cash payment as debt.

3.7.40 Product financing arrangements



Excerpt from ASC 470-40

05-1 This Subtopic establishes guidance for determining whether an arrangement involving the sale of inventory is in substance a financing arrangement.

05-2 Product financing arrangements include agreements in which a sponsor (the entity seeking to finance product pending its future use or resale) does any of the following:

- a. Sells the product to another entity (the entity through which the financing flows), and in a related transaction agrees to repurchase the product (or a substantially identical product)
- b. Arranges for another entity to purchase the product on the sponsor's behalf and, in a related transaction, agrees to purchase the product from the other entity
- c. Controls the disposition of the product that has been purchased by another entity in accordance with the arrangements described in either (a) or (b).

05-3 In all of the foregoing cases, the sponsor agrees to purchase the product, or processed goods of which the product is a component, from the other entity at specified prices over specified periods or, to the extent that it does not do so, guarantees resale prices to third parties (see paragraph 470-40-15-2(a)(1)). The Implementation Guidance in Section 470-40-55 illustrates the arrangement described in (b) of the preceding paragraph. For an arrangement described in (a), see Topic 606 on revenue from contracts with customers for guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78 and an illustration on repurchase agreements in Example 62, Case A, paragraphs 606-10-55-401 through 55-404.

05-4 Other characteristics that commonly exist in product financing arrangements but that are not necessarily present in all such arrangements include the following:

- a. The entity that purchases the product from the sponsor or purchases it directly from a third party on behalf of the sponsor was established expressly for that purpose or is an existing trust, nonbusiness entity, or credit grantor.
- b. The product covered by the financing arrangement is to be used or sold by the sponsor, although a portion may be sold by the other entity directly to third parties.
- c. The product covered by the financing arrangement is stored on the sponsor's premises.

- d. The debt of the entity that purchases the product being financed is guaranteed by the sponsor.

05-5 The following are similarities between a sponsor's rights and obligations under a product financing arrangement and a purchaser's rights and obligations under an **unconditional purchase obligation** (see Topic 440):

- a. Both the sponsor and the purchaser obtain probable future economic benefits from the assured source of product.
- b. Both are obligated to make future cash payments to the other party to the agreement.

05-6 Beyond those similarities, however, there is a substantial difference in the related accounting issues. Under a product financing arrangement, the product already exists and the other entity's purchase cost is known.

> Transactions

15-2 The guidance in this Subtopic applies to **product financing arrangements** for products that have been purchased by another entity on behalf of the sponsor and have both of the following characteristics:

- a. The financing arrangement requires the sponsor to purchase the product, a substantially identical product, or processed goods of which the product is a component at specified prices. The specified prices are not subject to change except for fluctuations due to finance and holding costs. This characteristic of predetermined prices also is present if any of the following circumstances exist:
 1. The specified prices in the financing arrangement are in the form of resale price guarantees under which the sponsor agrees to make up any difference between the specified price and the resale price for products sold to third parties.
 2. The sponsor is not required to purchase the product but has an option to purchase the product, the economic effect of which compels the sponsor to purchase the product; for example, an option arrangement that provides for a significant penalty if the sponsor does not exercise the option to purchase.
 3. The sponsor is not required by the agreement to purchase the product but the other entity has an option whereby it can require the sponsor to purchase the product.
- b. The payments that the other entity will receive on the transaction are established by the financing arrangement, and the amounts to be paid by the sponsor will be adjusted, as necessary, to cover substantially all fluctuations in costs incurred by the other entity in purchasing and holding the product (including interest). This characteristic ordinarily is not present in purchase commitments or contractor-subcontractor relationships.

15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Ordinary purchase commitments in which control of the good or service is retained by the seller (for example, a manufacturer or other supplier) until the good or service is transferred to a purchaser.
- b. Typical contractor-subcontractor relationships in which the contractor is not in substance the owner of product held by the subcontractor and the

- obligation of the contractor is contingent on substantial performance on the part of the subcontractor.
- c. Long-term **unconditional purchase obligations** (for example, **take-or-pay contracts**) specified by Subtopic 440-10 on commitments. At the time a take-or-pay contract is entered into, which is an unconditional purchase obligation, either the product does not yet exist (for example, electricity) or the product exists in a form unsuitable to the purchaser (for example, unmined coal); the purchaser has a right to receive future product but is not the substantive owner of existing product.
 - d. Unmined or unharvested natural resources and financial instruments.
 - e. **Contracts** within the scope of Topic 606 on **revenue** from contracts with **customers**. For example, contracts that are subject to a right of return as described in paragraph 606-10-32-10 and paragraphs 606-10-55-22 through 55-29 and contracts in which a sponsor (the entity seeking to finance product pending its future use or resale) sells the product to another entity (the entity through which the financing flows) and in a related transaction agrees to repurchase the product (or a substantially identical product). Such contracts are within the scope of Topic 606; see paragraphs 606-10-55-66 through 55-78 on repurchase agreements and paragraphs 606-10-55-36 through 55-40 on principal versus agent considerations.
 - f. Typical purchases by a subcontractor on behalf of a contractor. In a typical contractor-subcontractor relationship, the purchase of product by a subcontractor on behalf of a contractor ordinarily leaves a significant portion of the subcontractor's obligation unfulfilled. The subcontractor has the risks of ownership of the product until it has met all the terms of a contract. Accordingly, the typical contractor-subcontractor relationship shall not be considered a product financing arrangement.

25-1 This Subtopic requires that a **product financing arrangement** within the scope of this Subtopic be accounted for as a borrowing rather than as a sale. The sponsor is in substance the owner of the product and the sponsor shall, therefore, report the product as an asset and the related obligation as a liability.

25-2 If the sponsor is a party to an arrangement whereby another entity purchases a product on the sponsor's behalf and, in a related transaction, the sponsor agrees to purchase the product or processed goods of which the product is a component from the entity, the sponsor shall record the asset and the related liability when the product is purchased by the other entity.

25-3 Costs of the product, excluding processing costs, in excess of the other entity's purchase costs represent financing and holding costs. The sponsor shall account for such costs in accordance with the sponsor's accounting policies applicable to financing and holding costs as those costs are incurred by the other entity. For example, if insurance costs ordinarily are accounted for as period costs by the sponsor, similar costs associated with the product covered by financing arrangements shall be expensed by the sponsor as those costs are incurred by the other entity.

25-4 Interest costs associated with the product covered by financing arrangements shall be identified separately and accounted for by the sponsor in accordance with Topic 835 as those costs are incurred by the other entity.

- > Example 1: Sponsor Arranges for an Entity to Purchase Product and Sponsor Agrees to Purchase That Product

55-1 This Example illustrates how the guidance in paragraphs 470-40-25-1 through 25-4 applies to **product financing arrangements** in which a sponsor arranges for another entity to purchase the product on the sponsor's behalf and, in a related transaction, agrees to purchase the product from the other entity.

55-2 The facts assumed in this Example are illustrative only and are not intended to modify or limit in any way the provisions of this Subtopic. The facts assumed in the Example could vary in one or more respects without altering the application of the provisions of this Subtopic.

55-6 A sponsor arranges for another entity to buy product on the sponsor's behalf with a related agreement to purchase the product from the other entity.

55-7 The sponsor arranges for the other entity to purchase on its behalf an existing supply of fuel. In a related agreement, the sponsor agrees to purchase the fuel from the other entity over a specified period and at specified prices. The prices established are adequate to cover all financing and holding costs of the other entity. The other entity finances the purchase of fuel using the fuel and the agreement as collateral.

55-8 In this product financing arrangement, both of the characteristics in paragraphs 470-40-15-2 through 15-3 are present; accordingly, the sponsor reports the asset (fuel) and the related liability on its balance sheet when the fuel is acquired by the other entity. Financing and holding costs are accrued by the sponsor as incurred by the other entity and accounted for in accordance with the sponsor's accounting policies for financing and holding costs. Interest costs are separately identified and accounted for in accordance with Topic 835.

A product financing arrangement is a transaction in which an entity (the sponsor) sells inventory and agrees to repurchase it from the buyer at a future date with the repurchase price equal to the original sale price plus carrying and financing costs. [\[470-40 Glossary\]](#)

The distinguishing characteristic of a product financing arrangement is that, in substance, it represents a secured borrowing instead of a revenue-producing transaction or supply agreement. Entities often structure product financing arrangements as sales arrangements, but they are in substance financing arrangements that should be accounted for as such.

Product financing arrangements include agreements in which the sponsor (the entity seeking to finance product pending its future use or resale): [\[470-40-05-2\]](#)

- a. sells the product to another entity (the buyer/lender), and in a related transaction agrees to repurchase the product from the other entity.
- b. arranges for another entity to purchase the product for the sponsor, or the sponsor otherwise controls the product that another entity purchased on its behalf.

Topic 606 provides guidance on repurchase agreements discussed in (a) above. For further discussion on repurchase agreements, see section 7.5.50 of KPMG Handbook, [Revenue recognition](#).

Subtopic 470-40 provides guidance on product financing arrangements where the sponsor arranges for another entity to purchase the product on the sponsor's behalf and, in a related transaction, agrees to purchase the product from the other entity (discussed in (b) above).

These arrangements are for products that have been produced by or were originally purchased by the sponsor or purchased by another entity on behalf of the sponsor and have both of the following characteristics: [470-40-15-2]

- the financing arrangement requires the sponsor to purchase the product, a substantially identical product, or processed goods of which the product is a component, at specified prices. The specified prices may change due only to fluctuations in financing and holding costs (the 'specified price' requirement); and
- the payments that the buyer will receive on the transaction is established by the financing arrangement, and the amounts will be adjusted (as necessary) to include substantially all fluctuations in costs incurred by the buyer to purchase and hold the inventory, including interest.


 **Question 3.7.60**
What are some of the indicators that a series of transactions is a product financing arrangement?

Interpretive response: There are a number of indicators that suggest a series of transactions is a product financing arrangement, which are summarized as follows.

Indicator	Considerations
Buyer is not a substantive entity	<p>A sponsor should evaluate the substance of the buyer, considering whether the buyer has:</p> <ul style="list-style-type: none"> — a legitimate business purpose for entering into the transaction (other than providing financing to the sponsor); and — meaningful ongoing operations (other than as a financing conduit for the sponsor). <p>If the buyer does not possess these characteristics, we believe it is not a substantive entity; in that case, the transaction generally does not have substance and is accounted for as a product financing arrangement (not a sale). The buyer in that type of transaction should be evaluated under Topic 810 (consolidation) to determine whether it must be consolidated by the sponsor as a variable interest entity. For discussion of variable interest entities, see chapter 4 of KPMG Handbook, Consolidation.</p> <p>For example, a buyer may not have substance if it was established expressly to purchase the product from the sponsor or directly from a third party on behalf of the sponsor. Further, the substance of a buyer also may be questionable if it is an existing trust or a nonbusiness organization. Similarly, if the buyer is a lender, the transaction likely does not have substance because a lender would not normally purchase inventory in the</p>

Indicator	Considerations
	ordinary course of its business. The lender is only purchasing the inventory because the sponsor agreed to repurchase it or arranged for another party to repurchase it.
Sponsor will use or sell the product	<p>If the sponsor will use or sell the product covered by the arrangement, the transaction may be a product financing arrangement (not a sale). However, the sponsor is not required to repurchase the entire product to consider the transaction a product financing arrangement. The transaction may be a product financing arrangement even if the buyer may sell a portion of the product directly to a third party. [470-40-05-4(b)]</p> <p>Similarly, a sponsor is not required to repurchase the exact product for the transaction to be a product financing arrangement. The transaction may be a product financing arrangement and not a sale if a sponsor repurchases substantially identical products or processed goods of which the product is a component. [470-40-15-2]</p>
Product is stored on sponsor's premises	<p>If the product covered by the arrangement is stored on the sponsor's premises, it may indicate that the inventory has not been sold. [470-40-05-4]</p> <p>In addition to the criteria of Subtopic 470-40, a sale of goods that remain located on the sponsor's premises must meet all of the bill-and-hold criteria to qualify as a sale. Those criteria are: [606-10-55-83]</p> <ul style="list-style-type: none"> — the reason for the bill-and-hold must be substantive; — the product must be identified separately as belonging to the customer; — the product must be currently ready for physical transfer to the customer; and — the sponsor cannot have the ability to use the product or direct it to another customer. <p>For further discussion on bill-and-hold criteria, see section 7.5.30 of KPMG Handbook, Revenue recognition.</p>
Sponsor guarantees buyer's debt	<p>The sponsor guaranteeing the buyer's debt may indicate that the debt obligation relates to the sponsor and that the transaction may be a product financing arrangement (not a sale). [470-40-05-4]</p> <p>If the debt is not considered to be the sponsor's obligation under Subtopic 470-40, the sponsor must consider:</p> <ul style="list-style-type: none"> — the implications of the guarantee on revenue recognition; and — potentially (if revenue recognition is not precluded) whether to recognize the fair value of the guarantee under Topic 460 (guarantees).
Sponsor repurchases at a specified price	<p>A transaction may be a product financing arrangement and not a sale if: [470-40-15-2(a)(1)]</p> <ul style="list-style-type: none"> — the sponsor agrees to repurchase the product at a specified price; and — the buyer is not exposed to fluctuations in the market price during the intervening period. <p>In this context, an agreement that indicates that the repurchase price is based on the prevailing market price on the date of</p>

Indicator	Considerations
	repurchase is not a specified price and such arrangement is not a financing arrangement. [470-40-15-2(a)(1)]
Arrangement contains a resale price guarantee	A resale price guarantee causes an arrangement to meet the 'specified price' characteristic of a product financing arrangement. In that case, the buyer sells the product to a third party at a price negotiated by the two parties. However, the sponsor agrees to make up any difference to the buyer between the specified price and the resale price for products sold to third parties. [470-40-15-2(a)(1)]
Sponsor has option to repurchase the product	In some arrangements, the sponsor has the option (but is not required) to repurchase the product. However, the economic effect of not repurchasing the product may be so negative that the sponsor is compelled to undertake the repurchase. These arrangements meet the 'specified price' characteristic of a product financing arrangement. [470-10-5-2(a)(2)]
Buyer has a put option	A provision that enables the buyer to require the sponsor to repurchase the product (i.e. a put option) causes an arrangement to meet the 'specified price' characteristic of a product financing arrangement. [470-10-5-2(a)(3)]

 **Question 3.7.70**
What types of transactions generally do not qualify as product financing arrangements?

Interpretive response: There are two characteristics for a product financing arrangement to be in the scope of Subtopic 470-40: [470-40-15-2]

- the sponsor will pay a specified price for the inventory on repurchase; and
- the sponsor’s payment for repurchase of the inventory is established by the financing arrangement and the amounts will be adjusted (as necessary) to include substantially all fluctuations in costs incurred by the buyer to purchase and hold the inventory, including interest.


The following types of transactions are generally not financing arrangements in the scope of Subtopic 470-40 because they either fall under a scope exception within that guidance, or they do not meet the scope criteria in that guidance. If a transaction is not in the scope of Subtopic 470-40, an entity applies other guidance to determine the proper accounting for the transaction. [470-40-15-3]

Ordinary purchase commitments [470-40-15-3(a)]	<p>The purpose of an ordinary purchase commitment is to assure the supply of product and not to provide financing to the seller. In an ordinary purchase commitment, a buyer agrees to purchase a product from a seller.</p> <p>An ordinary purchase commitment is not a product financing arrangement because ownership of the product has not been transferred from the seller to the buyer and the buyer has not remitted cash to the seller. The seller retains control until the product is transferred to the</p>
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	<p>purchaser, so an unconditional purchase commitment ordinarily will not meet the second scope characteristic.</p>
<p>Contractor-subcontractor relationships [470-40-15-3(b)]</p>	<p>A contractor-subcontractor relationship in which the subcontractor purchases a product on behalf of the contractor generally is not a product financing arrangement.</p> <p>In a typical contractor-subcontractor relationship, the subcontractor purchases a product on behalf of the contractor with the expectation that the product will be sold to the contractor on completion of the work. The purchase of the product ordinarily leaves a significant portion of the subcontractor's obligation unfulfilled. The subcontractor assumes many of the risks of ownership of the product until it has met all of the terms of the contract, so the second scope characteristic is not met.</p> <p>Further, in a cost-plus arrangement the amount paid to the subcontractor may depend on variable factors other than holding and financing costs (e.g. labor costs) and therefore does not constitute a specified price as required by the first scope characteristic.</p> <p>For an arrangement to qualify as a product financing arrangement, the sponsor must commit to purchase the product at a specified price that relieves the buyer of risks associated with storing and holding the product.</p>
<p>Take-or-pay contracts [470-40-15-3(c)]</p>	<p>A take-or-pay contract is an unconditional purchase obligation for a fixed or minimum amount of goods or services at fixed or minimum prices. Under a take-or-pay contract, an entity agrees to pay a specified price for a specified product regardless of whether it takes delivery of the product.</p> <p>A take-or-pay contract is not a product financing arrangement because either the product does not yet exist, or it exists in a form unsuitable to the buyer. The buyer has a right to receive future product but is not the substantive owner of an existing product.</p>
<p>Unmined or unharvested natural resources [470-40-15-3(d)]</p>	<p>Unmined or unharvested natural resources are not considered to be products when applying Subtopic 470-40.</p> <p>Depending on the facts and circumstances, an entity should consider Subtopic 976-605 (real estate revenue recognition) and paragraphs 470-10-25-1 and 25-2 on sales of future revenue, Topic 932 (oil and gas), Topic 842 (leases) or other applicable guidance when evaluating sales of unmined or unharvested resources.</p> <p>Obligations to repurchase natural resources at a specified price will generally preclude sale accounting under that guidance. Further, a sale of natural resources in exchange for a futures or forward contract (often called an exchange for physicals or an EFP transaction) may represent a derivative under Topic 815.</p>
<p>Financial instruments [470-40-15-3(d)]</p>	<p>Subtopic 470-40 does not cover arrangements that involve the sale and repurchase of financial instruments. Instead, Topic 860 (transfers and servicing) applies when considering whether financial instruments should be derecognized in arrangements that are similar to those described in Subtopic</p>

	470-40 that involve the sale and subsequent repurchase of financial instruments (e.g. repo transactions).
Sales of future revenue	Subtopic 470-40 does not address sales of future revenue, which also may require accounting as financing transactions based on the facts and circumstances. If a transaction involves the sale of future revenue, an entity should refer to the criteria outlined in paragraph 470-10-25-2 to determine whether to recognize the amounts received as debt or deferred revenue (see section 3.7.30).

Certain arrangements similar to those described in Subtopic 470-40 may require an entity to consider Topic 845 (nonmonetary transactions). This guidance requires most exchanges of inventory in the same line of business to be recorded at carryover basis (not fair value) in the financial statements. Those transactions are recorded as exchanges and do not result in the recognition of revenue. Topic 845 applies to nonmonetary exchanges as well as to monetary exchanges in which money is exchanged but the sale and purchase of inventory in the same line of business are made in contemplation of one another. [845-10-25-4, 55-10 – 55-26]

 **Question 3.7.80**
How does the sponsor account for a product financing arrangement?

Interpretive response: Because a product financing arrangement is not a sale, the sponsor accounts for the transaction as follows. [470-40-25-2]

Transaction	Accounting
Sponsor sells a product to another entity and, in a related transaction, agrees to repurchase the product (or a substantially identical product) or processed goods of which the product is a component.	Sponsor records a liability at the time the proceeds are received from the other entity to the extent the product is covered by the financing arrangement. Sponsor does not remove the covered product from its balance sheet.
Sponsor is a party to an arrangement whereby another entity purchases a product on the sponsor's behalf and, in a related transaction, sponsor agrees to purchase the product or processed goods of which the product is a component from the entity.	Sponsor records the asset and the related liability when the product is purchased by the other entity.

Costs of the product, excluding processing costs, in excess of the sponsor's original production or purchase costs or the other entity's purchase costs represent financing and holding costs. Because the sponsor reimburses the buyer for any carrying and financing costs, it recognizes those costs in its income statement in line with its accounting policy for finance and holding costs. [470-40-25-3 – 25-4]

Further, the sponsor may incur product processing costs. For example, an auto manufacturer may sell steel to a parts supplier and in a related transaction agree to purchase component parts from the supplier containing a similar amount of steel. The price of the component parts includes processing, holding, and financing costs. The auto manufacturer should separately identify any processing costs from financing and holding costs and record processing costs as incurred as part of the cost of the product processing.



Question 3.7.90

Is an arrangement that does not qualify as a product financing arrangement accounted for as a sale?

Interpretive response: Not necessarily. An entity should not necessarily treat an arrangement that does not qualify as a product financing arrangement under Subtopic 470-40 as a normal sale or a normal supply arrangement by default.

Instead, the entity should consider guidance in other Topics when evaluating the arrangement, including the following.

<p>Topic 845 (nonmonetary transactions)</p>	<p>Topic 845 should be evaluated to determine whether sales of product to counterparties that are accompanied by purchases of product (or commitments to purchase product) in the same line of business should be treated as like-kind exchanges instead of sales.</p> <p>Topic 815 may apply if the repurchase arrangement constitutes a derivative, in which case Topic 845 does not apply.</p>
<p>Subtopic 810-10 (consolidation)</p>	<p>Subtopic 810-10 should be evaluated to determine whether a buyer is without substance and should be consolidated as a variable interest entity.</p> <p>See chapter 4 of KPMG Handbook, Consolidation.</p>
<p>Topic 842 (leases)</p>	<p>Topic 842 should be evaluated to determine whether take-or-pay and similar contracts are or contain a lease for the related property, plant and equipment.</p> <p>Take-or-pay contracts require the purchaser to pay specified amounts periodically in return for products or services. Minimum payments are required even if the purchaser does not take delivery of the products or services.</p> <p>See chapter 7 of KPMG Handbook, Leases.</p>
<p>Topic 606 (revenue)</p>	<p>Topic 606 should be evaluated to determine whether sales of goods that remain at the sponsor's location (i.e. bill and-hold-transactions) qualify for revenue recognition.</p> <p>See chapter 7 of KPMG Handbook, Revenue recognition.</p>

**Question 3.7.95****

Is a product financing arrangement a derivative if the sponsor agrees to purchase inventory at a fixed price (plus carrying and financing costs)?

Background: A derivative is a financial instrument or other contract that has all of the following characteristics: [815-10-15-83]

- underlying, notional and/or payment provision;
- no or small initial net investment; and
- net settleable.

For further detail, see chapter 3 of KPMG Handbook, [Derivatives and hedging](#).

An arrangement to purchase inventory at a fixed price can have these characteristics, including that some arrangements meet the net settlement characteristic (e.g. contractual net settlement in termination clauses or delivery of a commodity that is readily convertible to cash).

Interpretive response: No. When an agreement to purchase inventory is accounted for as a product financing arrangement, the sponsor records the inventory and related liability when the inventory is purchased by the vendor on the sponsor's behalf (i.e. at the inception of the forward purchase contract); see Question 3.7.80. Recording the purchase obligation as a derivative in addition to recording the liability would result in accounting for essentially the same value twice (first by recording the liability, then by recording the purchase obligation derivative). Topic 815 provides scope exceptions that were intended to avoid such double-counting and those concepts also apply to product financing arrangements; see KPMG Handbook, [Derivatives and hedging](#), about regular-way security trades (section 2.3) and derivatives that impede sale accounting (section 2.8). Therefore, the forward purchase contract is not accounted for as a derivative. [815-10-15-63, 15-83(b), FAS 133.BC284]

**Example 3.7.30**

Repurchase price is at current market rate

On December 31, Year 4, ABC Corp. (a mining company) sells 40,000 pounds of copper to Manufacturer for \$100,000. The copper has a cost of \$80,000. Legal title to the copper passes from ABC to Manufacturer.

Manufacturer uses the copper as collateral to obtain a bank loan and then uses the proceeds from the loan to pay ABC for the copper. In a separate transaction on the same day, ABC agrees to repurchase 40,000 pounds of copper from Manufacturer over the next three months at the prevailing market price.

Although the price at which ABC will repurchase the inventory appears to be specified (i.e. the prevailing market price), it is not fixed. Specifically, the price at which ABC must repurchase the copper is subject to changes in the market price of copper; the price changes are not limited solely to fluctuations due to finance and holding costs. Therefore, this transaction is not a product financing arrangement under Subtopic 470-40 because the transaction does not meet the

scope requirements of that Subtopic – i.e. the transaction price will be at the then-current fair value of the product and not at a fixed price.

While this arrangement likely is not in the scope of Topic 606 (i.e. it may be viewed as an exchange of inventory subject to Topic 845), ABC should analyze the transaction under the literature to determine the proper accounting.

For example, if ABC determines that this transaction is not a sale and instead represents an exchange of inventory under Topic 845 or debt with Manufacturer, ABC may conclude that the transaction represents a debt host contract with an embedded copper derivative under Topic 815. In that case, the proceeds received at inception of the arrangement by ABC may be recorded as a liability (which is accreted to the proceeds received at inception as interest expense) and a bifurcated copper derivative (which is subsequently fair valued with changes in fair value recognized in earnings). For further guidance on accounting for derivatives, see KPMG Handbook, [Derivatives and hedging](#).



Example 3.7.40

Sponsor arranges for a third party to purchase product

Sponsor contracts with Buyer to purchase inventory from a supplier and hold the inventory on its behalf.

- Buyer will purchase inventory from a supplier and store certain ingredients used to produce Sponsor's products with Sponsor's written approval.
- Buyer will notify Sponsor of the purchase prices of the inventory it acquires.
- During the period that Buyer holds the inventory, Sponsor is required to make quarterly payments to cover Buyer's holding costs (e.g. insurance and storage costs) and financing costs.
- Buyer will ship the inventory to Sponsor on request, at which time Sponsor is required to pay an amount equal to Buyer's original purchase price plus financing and holding costs that have accrued since the last payment date. Sponsor assumes title and risk of loss to the inventory at the time of shipment to Sponsor.

This arrangement meets both scope criteria in paragraph 470-40-15-2 even though the buyer originally purchases the inventory from a third party. Therefore, the arrangement is in the scope of Subtopic 470-40.

Sponsor records the asset (inventory) and the related liability on its balance sheet when the third party acquires the inventory. Sponsor accrues financing and holding costs as incurred by Buyer and accounts for those costs in accordance with its accounting policies for financing and holding costs. Sponsor separately identifies and accounts for interest cost under Topic 835 (interest).

3.7.50 Increasing-rate debt



Excerpt from ASC 470-10

> Increasing Rate Debt

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

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

A debtor first analyzes whether to separate the term-extending provisions of a debt instrument from the debt instrument and account for those provisions as a derivative under Topic 815 (see section 9.3). If the term-extending provisions are not separated and accounted for as a derivative under Topic 815, during each period that an increasing-rate debt is outstanding, the debtor needs to determine the interest cost for the period based on the estimated remaining term of the debt. [470-10-35-1]

When estimating the debt's term, the debtor should consider its ability and intent to service the debt. It also may consider its intent and ability to renew the debt, because this renewal right is included in the debt instrument. However, the estimated term of the debt cannot exceed the final maturity specified in the debt instrument. [470-10-35-2]



Question 3.7.100

How is periodic interest cost calculated on increasing-rate debt?

Interpretive response: During each period, we believe a debtor should evaluate the estimated term of the debt and calculate a weighted-average interest rate based on the interest escalation clauses in the remainder of the expected term. The weighted-average interest rate is used to calculate the interest cost each period.

A debtor should prospectively account for changes to the estimated term of the debt and the corresponding changes to the weighted-average interest rate.



Example 3.7.50 Non-prepayable increasing-rate debt

On January 1, Year 4, Debtor issues debt with the following provisions:

- Par value: \$100,000
- Initial maturity: April 1, Year 4
- Debtor option to extend: every three months until final maturity
- Final maturity: January 1, Year 9 (five-year maximum duration)
- Stated interest rate before any extensions: 5%
- Increase in stated interest rate per extension: 25 bps.

The debt instrument does not include any embedded features that were bifurcated.

Each reporting period, Debtor evaluates its ability and intent to extend the maturity. On issuance and throughout Years 4 and 5, Debtor estimates that the debt will be outstanding for two years.

Debtor records the following journal entry on issuance of the note.

	<i>Debit</i>	<i>Credit</i>
Cash	100,000	
Note payable		100,000
<i>To recognize note payable.</i>		

Interest expense for Year 4 is calculated based on the weighted-average interest rate over the estimated two-year duration of the debt as follows.

Period	Rate	
Year 4	January 1 – March 31	5.00%
	April 1 – June 30	5.25%
	July 1 – September 30	5.50%
	October 1 – December 31	5.75%
Year 5	January 1 – March 31	6.00%
	April 1 – June 30	6.25%
	July 1 – September 30	6.50%
	October 1 – December 31	6.75%
Weighted average	5.875%	

Debtor records interest expense using the weighted-average rate of 5.875%. As a result, interest expense for Year 4 is \$5,875 (\$100,000 principal balance × 5.875%). However, the cash interest cost is only \$5,375 for Year 4, calculated as follows.

Period	Rate	Balance	Interest ¹
Year 4			
January 1 – March 31	5.00%	\$100,000	\$1,250
April 1 – June 30	5.25%	100,000	1,312
July 1 – September 30	5.50%	100,000	1,375
October 1 – December 31	5.75%	100,000	1,438
			\$5,375
Note:			
1. Balance × Rate × 3/12, reflecting the change in rates every three months.			

Debtor records the following journal entry for interest expense in Year 4.

	Debit	Credit
Interest expense	5,875	
Cash		5,375
Accrued interest payable		500
<i>To recognize interest expense.</i>		

The accrued interest payable of \$500 will be reversed in Year 5 when the cash paid for interest will exceed interest expense. This will occur because interest expense will be based on the effective interest rate of 5.875%, and the cash paid for interest will be based on the stated interest rates of 6.00% to 6.75%.

3.7.60 Joint and several liabilities (Subtopic 405-40)



Excerpt from ASC 405-40

> Overall Guidance

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

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

For the total amount of an obligation under an arrangement to be considered fixed at the reporting date there can be no measurement uncertainty at the reporting date relating to the total amount of the obligation within the scope of this Subtopic. However, the total amount of the obligation may change subsequently because of factors that are unrelated to measurement

uncertainty. For example, the amount may be fixed at the reporting date but change in future periods because an additional amount was borrowed under a line of credit for which an entity is jointly and severally liable or because the interest rate on a joint and several liability arrangement changed.

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

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

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

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

30-1 Obligations resulting from joint and several liability arrangements included in the scope of this Subtopic initially shall be measured as the sum of the following:

- a. The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors.
- b. Any additional amount the reporting entity expects to pay on behalf of its co-obligors. If some amount within a range of the additional amount the reporting entity expects to pay is a better estimate than any other amount within the range, that amount shall be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range shall be the additional amount included in the measurement of the obligation.

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

35-1 Obligations resulting from joint and several liability arrangements included in the scope of this Subtopic subsequently shall be measured using the guidance in Section 405-40-30.

The term joint and several liability refers to a borrowing or other arrangement in which more than one entity is identified as a co-borrower or payor and all borrowers/payors are jointly and severally liable for the entire amount of the borrowing/payment. The counterparty can demand payment (in accordance with the terms) from any one or a combination of borrowers/payors. Joint and

several arrangements commonly involve related parties or affiliates (e.g. a debt arrangement) but can be between unrelated parties (e.g. a judicial ruling).

Arrangements, such as debt agreements, that are fixed at inception or judicial rulings that become fixed, are typical arrangements that may be in the scope of Topic 405-40. Just the total amount of the obligation of the debtor and its co-obligors must be fixed at the reporting date to be in the scope of Subtopic 405-40. The amount the debtor expects to pay on behalf of its co-obligors does not need to be fixed at the reporting date. [405-40-15-1, 25-1]

A debtor initially and subsequently measures its liability under Subtopic 405-40 based on the following: [405-40-30-1 – 30-2, 35-1]

- the amount it has agreed to pay under the arrangement with its co-obligors; plus
- any additional amount it expects to pay on behalf of its co-obligors.

The measurement of the amount a debtor has agreed to pay under the arrangement with its co-obligors will likely be based on amounts contained in the arrangement itself (e.g. a debt agreement or a separate agreement with the co-obligors), which determines the amounts each entity has agreed to pay. The additional amount a debtor expects to pay on behalf of its co-obligors will require judgment (see Question 3.7.110).



Question 3.7.110

What does a debtor need to consider in recording a liability for an additional amount on behalf of its co-obligors?

Interpretive response: In most situations, the agreement between co-obligors determines the amount that each co-obligor has agreed to pay. For example, debt agreements typically indicate how proceeds are used and distributed among co-obligors. If no formal agreement exists, we believe that a debtor should measure its stand-alone obligation based on the minimum it has agreed to pay the creditor(s).

However, a debtor may expect to pay an amount on behalf of its co-obligors in addition to the amount specified by the formal agreement. For example, a parent company may issue debt on behalf of its co-obligor subsidiary but does not have the financial ability to repay the debt without the operations of the subsidiary. In this case, we believe the subsidiary should record some, or all, of the obligation regardless of whether a formal agreement is in place or proceeds have been distributed to the subsidiary. Judgment is required in determining the appropriate amount to record, including consideration of the proceeds each co-obligor expects to receive and its ability to repay the debt.

The additional amount, if any, to be recorded is based solely on the additional amount the debtor expects to pay – not an amount based on the probable recognition threshold like Topic 450 (contingencies).

In our experience, a debtor may determine the amount it expects to pay on behalf of other co-obligors based on the following (not exhaustive):

- the current and forecasted financial condition of each co-obligor to determine if each co-obligor can pay its share of the obligation;
- management's plan to meet debt payment obligations initially assigned to a co-obligor;
- other indications of a co-obligor's inability to pay (e.g. going concern, liquidity events, impairments); and
- historical analysis of what, if anything, the debtor has paid on behalf of other co-obligors.



Question 3.7.120

Does a debtor record a receivable if it is entitled to recover amounts it pays for co-obligors?

Interpretive response: It depends on whether an agreement exists that entitles the debtor to recover such amounts. If there is such an agreement, the debtor recognizes a receivable at the time the corresponding liability is established, with an appropriate assessment of the credit loss on that receivable. [405-40-25-2]

If no agreement exists, the debtor should consider the specific facts and circumstances to determine whether other guidance applies in recognizing a receivable for potential recovery. For example, it may be appropriate to consider whether gain contingency guidance under Subtopic 450-30 applies.



Example 3.7.60

Joint and several liability arrangement

On January 1, Year 4, Regional Healthcare System (RHS) issues conduit debt under the terms of a master trust agreement, which identifies three of the system's wholly owned subsidiaries (Hospitals A, B and C) as members of the obligated group (members or obligors).

The master trust agreement stipulates that the debt holders can demand payment of the total amount of the borrowings from any one or a combination of obligors. Each obligor is primarily responsible and cannot refuse to pay on the basis that the other obligors are also required to perform. Under a separate arrangement between the co-obligors, the paying obligor has the right to pursue repayment from the other obligors for amounts paid in excess of its allocated portion of the debt.

RHS issues tax-exempt bonds totaling \$30 million under the terms of the master trust agreement. The bond agreement notes that the proceeds are distributed equally to each member of the obligated group (i.e. \$10 million to each obligor) to finance their respective capital projects.

After issuing the bonds on December 31, Year 4, Hospital C experiences financial difficulty and may not be able to meet its obligation for bond payments

due ranging between \$400,000 and \$800,000. RHS's management concludes that the best estimate of this amount (i.e. the amount it expects to pay) is \$500,000.

RHS's board of directors then approves a plan for Hospital A to fund Hospital C's debt payment and to record an intercompany receivable due from Hospital C for this amount.

Initial recognition and measurement of bonds

On issuance of the bond on January 1, Year 4, Hospital A records a liability for the obligation equal to the amount it has agreed to pay (i.e. \$10 million). On December 31, Year 4, it records the additional amount it expects to pay (i.e. \$500,000) once it is determined that Hospital C may not be able to meet its obligation, for a total obligation of \$10.5 million. Hospital A also records an intercompany receivable of \$500,000 due from Hospital C, which it reduces by any allowance deemed necessary. Due to Hospital C's financial difficulties, Hospital A concludes that a full allowance of \$500,000 is necessary and recognizes a \$500,000 loss for the additional amount it expects to pay.

Hospital A records the following journal entry on January 1, Year 4.

	<i>Debit</i>	<i>Credit</i>
Cash	10,000,000	
Bonds payable		10,000,000
<i>To recognize issuance of bond.</i>		

Subsequent measurement of bonds

On December 31, Year 4 Hospital A records the following journal entries after determining that Hospital C may not be able to meet its obligation.

	<i>Debit</i>	<i>Credit</i>
Intercompany receivable ²	500,000	
Bonds payable ¹		500,000
<i>To record additional liability under bond issuance.</i>		
Credit loss expense (on co-obligated bonds) ²	500,000	
Allowance for uncollectible receivables (intercompany)		500,000
<i>To recognize allowance for loss on intercompany receivable.</i>		

Notes:

- Hospital A records the additional amount it expects to pay for Hospital C's obligation.
- Hospital A records an intercompany receivable for the portion it expects to pay for Hospital C's obligation. An allowance is established against the receivable, with a corresponding loss recorded, because the receivable is not expected to be collected from Hospital C due to its financial difficulty. A full allowance is recorded based on Hospital A's assessment of collectibility.

Note: If no amount in the range is a better estimate than any other amount, Hospital A would record a liability of \$10,400,000 (the \$10 million Hospital A agreed to pay plus \$400,000, the minimum amount in the range expected to be paid for Hospital C). Hospital A records the portion of the debt obligated per the terms of the debt arrangement.

3.7.70 Structured payable arrangements

Structured payable arrangements often involve an entity negotiating extended payment terms with one or more vendors (e.g. going from 30 days to 60 days) and also entering into a payables processing agreement with a paying agent (e.g. a bank or other financial institution) that will make payments to vendors on behalf of the entity.

Under the terms of the payables processing agreement, the entity provides invoice information to the paying agent (including the total due, payment due date, and other terms negotiated between the entity and the vendor). The paying agent then remits invoice payments to vendors on behalf of the entity based on instructions from the entity. The paying agent may use the invoice information to identify the entity's vendors and attempt to enter into a factoring arrangement where the paying agent agrees to purchase from the vendor amounts owed by the entity.

These arrangements are commonly referred to as structured payables, supply chain financing, supplier finance programs or vendor financing arrangements.

Subtopic 405-50 requires buyers to disclose information about certain supplier finance programs; see section 3.8.30 for guidance about the required disclosures and the programs for which they are required. Other than those disclosures, there is no guidance in US GAAP that specifically addresses the accounting for trade accounts payable affected by supplier finance programs. However, the SEC staff has provided views on when these obligations should no longer be classified as trade accounts payable and the related accounting effects. The SEC staff also expects a registrant to provide disclosures about these programs in its MD&A.



Question 3.7.130

What are some of the considerations in evaluating the effect of a structured payable arrangement on trade accounts payable classification?

Interpretive response: There is no guidance in US GAAP that specifically addresses the accounting for trade accounts payable affected by a structured payable arrangement, including when classification as trade accounts payable is no longer appropriate. Generally, transactions among creditors are disregarded for accounting purposes by the debtor (e.g. a debt instrument transferred from one debt holder to another). However, based on comments made, the SEC staff believes a thorough analysis of all the facts and circumstances specific to the individual transaction is necessary to determine the appropriate accounting

for trade accounts payable affected by a structured payable arrangement. [\[2003 AICPA Conf, 2004 AICPA Conf\]](#)

For example, the SEC staff believes the substance of a structured payable arrangement may equate to the entity obtaining financing from a lender to pay amounts due to its vendors. An entity's analysis of the accounting for a structured payable arrangement should consider the totality of the arrangement, including the roles, responsibilities and relationships of each party to the arrangement.

The SEC staff has suggested that any one of the following may indicate that trade accounts payable classification by the entity is no longer appropriate: [\[2004 AICPA Conf\]](#)

- the paying agent makes any sort of referral or rebate payment to the entity;
- the paying agent reduces the amount due from the entity, such that the amount due is less than the amount the entity is obligated to pay the vendor on the original invoice's due date;
- the paying agent extends the entity's payment date beyond the invoice's original due date; or
- the entity actively participates in the process of factoring the vendor's receivable to the paying agent.

There is significant diversity in the structure and terms of structured payable arrangements offered by financial institutions, and therefore a careful analysis of all relevant facts and circumstances related to the substance of the transaction is necessary. We believe an entity's evaluation should focus on what, if anything, has changed as a result of entering into the structured payable arrangement or as a result of the vendor factoring its receivable to the paying agent. Also relevant is the entity's role in the factoring agreement between the paying agent and the vendor.

In many of these arrangements, the common factor is that the paying agent targets an entity's vendors that have lower credit ratings than the entity. Such an arrangement may benefit the vendors because the paying agent relies on the entity (with a higher credit rating) to make the payment on the due date enabling the vendors to discount their receivable to the paying agent at a lower discount rate. Therefore, the paying agent typically focuses on the entity's credit rating when valuing (discounting) trade payables from the entity.

Additional considerations

In addition to the considerations identified by the SEC staff, we believe that any one of the following may also indicate that trade accounts payable classification by the entity is no longer appropriate.

- The terms of the invoice between the entity and the vendor change when the vendor factors its receivable to the paying agent (e.g. amount due, due date), including situations where the entity is obligated to pay interest on outstanding balances beginning when the vendor factors its receivable to the paying agent.
- The entity receives a benefit or concession from the paying agent or vendor – e.g. a portion of the discount the paying agent charges the vendor for factoring the vendor's receivable.

- The entity is required to reimburse the vendor for a portion of the difference between the invoice amount and the amount for which the vendor factors its receivable to the paying agent.
- The entity loses its ability to take advantage of early pay discounts (e.g. 2/10 net 30) as a result of providing invoice information to the paying agent or the vendor factoring the receivable to the paying agent.
- The vendor includes an implicit or explicit interest component in the pricing offered to the entity for its goods or services – e.g. the cost of the goods or services is above market rates.
- The entity does not retain its right to negotiate and realize credit memos with the vendor – e.g. returns, chargebacks, defects.
- The extended payment terms negotiated between the entity and the vendor are not representative of the standard terms in the entity's industry, jurisdiction, across a broad range of its suppliers, etc. – e.g. payment is typically due between 20 and 30 days for all similar vendors, but the entity has negotiated payment in 60 days because of the specific vendor participating in the structured payable arrangement with the paying agent.
- The invoice has been legally extinguished (legal conclusion) based on the conditions in paragraph 405-20-40-1 when the vendor factors its receivable to the paying agent.
- The entity is a party to the factoring arrangement between the vendor and the paying agent (i.e. it is a tri-party arrangement) or is directly involved in negotiating the terms between the vendor and the paying agent. This includes situations where the entity is involved in the vendor's decision to enter into a factoring arrangement with the paying agent (e.g. the vendor is required to participate to remain one of the entity's vendors) or to sell its receivables from the entity.
- The paying agent has discretion over which invoices the entity pays and when – e.g. if there are insufficient funds in the entity's bank account and the paying agent can unilaterally decide which invoices will be paid when due.
- The paying agent has the ability to draw down on one of the entity's bank accounts without the entity's permission if the account the entity originally instructs the paying agent to use to pay the invoice has insufficient funds.
- The paying agent requires the parent company to be jointly and severally liable for its subsidiary's obligation to settle its trade accounts payable.
- The paying agent requires the parent company (the entity or another subsidiary) to separately guarantee the payment for any trade accounts payable that the paying agent purchases.
- The fees paid by the entity to the paying agent vary based on the level of activity between the entity's vendors and the paying agent.
- The entity and the paying agent are parties to a separate arrangement (e.g. a credit facility entered into several years before the structured payable arrangement) that includes a clause that may:

- alter the seniority of trade accounts payable in the entity's capital structure – e.g. they become junior to debt outstanding under a credit facility but senior to trade accounts payable that have not been factored by vendors to the paying agent;
- require an immediate drawdown of existing or new lines of credit;
- require the entity to post collateral to secure the collectibility of the trade accounts payable; or
- incorporate cross-default provisions that would accelerate payment of the trade accounts payable if the entity breaches covenants or defaults on other obligations.



Question 3.7.140

What is the accounting effect when the classification of payables as trade accounts payable is no longer appropriate?

Interpretive response: If classification as trade accounts payable is no longer appropriate (see Question 3.7.130), the SEC staff has concluded that: [\[2004 AICPA Conf\]](#)

- the entity's liability is extinguished under paragraph 405-20-40-1 when the paying agent remits payment to the vendor; and
- the liability should be reflected as an amount payable to a bank for borrowings instead of as an amount payable to a trade creditor under Reg S-X Rule 5-02.19.

For a discussion on presentation in the statement of cash flows, see section 12.4 of KPMG Handbook, [Statement of cash flows](#).



Question 3.7.150

What is the accounting effect when a trade accounts payable is factored by the vendor to the paying agent?

Interpretive response: If classification as trade accounts payable continues to be appropriate (see Question 3.7.130), we believe there is no effect on the balance sheet or the statement of cash flows when the invoice is factored by the vendor to the paying agent. This is because the transaction between creditors (i.e. the factoring agreement between the vendor and the paying agent) is ignored for accounting purposes. [\[470-50-55-6\]](#)



Question 3.7.160

What MD&A disclosures should an SEC registrant consider regarding structured payable arrangements?

Interpretive response: The SEC staff has reminded registrants about the types of disclosures they expect to see in MD&A if an entity has entered into or plans to enter into structured payable arrangements and such programs are material to the current period or are reasonably likely to materially impact liquidity in the future. [\[2019 AICPA Conf\]](#)

Disclosures to consider include: [\[2019 AICPA Conf\]](#)

- the material and relevant terms of the program along with the general benefits and risks introduced by the arrangement;
- any guarantees provided by subsidiaries and/or the parent in relation to these programs;
- any plan to further extend terms to suppliers, and the factors that may limit the ability to continue to increase operating cash flows using this strategy in the future; and
- information about trends and uncertainties related to the extended payment terms for these arrangements – e.g. information about period-end accounts payable and intra-period variations.

Further, the SEC staff indicated that registrants could analogize to the guidance in the SEC Interpretive Release on the presentation of liquidity and capital resources disclosure in MD&A for illustrative disclosures over short-term borrowings that may be meaningful to the users of the financial statements. [\[SEC Rel 33-9144\]](#)

3.7.80 Purchasing card arrangements

A purchasing card (or P-card) is a form of corporate credit card that allows an entity to make electronic payments for business expenditures. P-cards require similar considerations as structured payable arrangements in evaluating the classification of the obligations as trade accounts payable or bank debt. US GAAP does not address how an entity should classify liabilities associated with an entity's use of P-cards or similar types of cards to pay for business expenditures.



Question 3.7.170

Are an entity's obligations payable to the issuer of a P-card classified as trade accounts payable or bank debt?

Interpretive response: It depends. When a P-card has been used to pay amounts owed to a vendor, the entity has extinguished its liability to the vendor

and incurred an obligation to the issuer of the P-card. Accordingly, the entity generally classifies obligations arising from the use of P-cards as debt payable to the issuer of the P-card (instead of as trade accounts payable), on the balance sheet. [2003 AICPA Conf]

Although the entity may be legally obligated to make the payment to the issuer of the P-card, we believe it may be acceptable for the obligation to be classified as trade accounts payable when the P-card was used for convenience (instead of for financing purposes) for the following types of purchases, and no interest costs are expected to be incurred:

- an incidental expenditure (e.g. travel, entertainment) incurred at the point-of-sale (i.e. the expenditure did not follow the vendor's traditional invoicing process) when the entity intends to settle the amounts due to the issuer of the P-card within the customary payment period for such cards (e.g. 30-60 days of the charge on the card);
- a normal operating expenditure (e.g. supplies, inventory) when the entity intends to settle the amounts due to the issuer of the P-card within the customary payment period, and the entity's payment terms with the issuer of the P-card are generally not extended by more than an insignificant period of time beyond the vendor's standard payment terms.



Example 3.7.70 P-card arrangements

Scenario 1: Company A uses P-card at point-of-sale for incidental expenditures

Employees of Company A are provided P-cards issued by Bank that allow them to make electronic payments for business expenditures incurred at the point-of sale. Company A owes Bank directly for any costs incurred and Company A settles amounts charged to the P-Card with Bank within the card's customary payment period. No financing or interest costs are incurred as long as Company A settles amounts due to Bank on time. Company A intends to settle the amounts due to the issuer of the P-card within the customary payment period.

In this scenario, it would be acceptable for Company A's obligation to Bank to be classified as trade accounts payable, because:

- the P-card was used by Company A for convenience purposes, not for financing;
- the purchases were for incidental expenditures incurred at the point-of-sale;
- Company A intends to settle the amounts due to the issuer of the P-card within the card's customary payment period; and
- no interest costs are expected to be incurred.

Scenario 2: Company B uses P-card to make payment on invoice due date for normal operating expenditures

Company B purchases \$100 of inventory from Supplier on September 2. Supplier's standard payment terms are net 60. On November 1 (the invoice due date), Company B uses its P-card (issued by Bank) to make the payment to

Supplier. After that, Company B does not owe Supplier any amount for the inventory purchased. Instead, Company B owes Bank \$100.

Per the terms of the arrangement with Bank, Company B settles all monthly charges to the P-card by the end of the following month. Company B will receive the November 30 statement from Bank that includes the \$100 charge, and the payment will be due to Bank on or before December 31. Company B intends to settle the amounts due to Bank by December 31.

In this scenario, it would not be appropriate for Company B's obligation to Bank to be classified as trade accounts payable. This is because Company B's payment terms were extended by more than an insignificant period of time beyond the Supplier's invoice due date under its standard payment terms.

Scenario 3: Company B uses P-card to make payment on an expedited due date for normal operating expenditures in connection with an arrangement with the supplier

Assume the same facts as Scenario 2, except that Company B, Supplier and Bank have entered into an arrangement whereby, in connection with Supplier's working capital management strategy, Supplier receives expedited settlement from Bank in 20 days from the date the expenditure was incurred.

On September 22 (the expedited due date in connection with the arrangement), Company B uses the P-card to settle the invoice, and in doing so, Bank remits \$100 to Supplier to settle the amounts due under the arrangement. Company B will receive the September 30 statement from Bank that includes the \$100 charge, and it will be due to Bank on or before October 31 (the day before the supplier invoice would have been due under its standard payment terms). Company B intends to settle the amounts due to Bank by October 31.

In this scenario, it would be acceptable for Company B's obligation to Bank to be classified as trade accounts payable, given that:

- the P-card was used by Company B for convenience purposes, not for financing;
- the purchase was for a normal operating expenditure;
- Company B intends to settle the amounts due to the issuer of the P-card within the customary payment period;
- no interest costs are expected to be incurred; and
- Company B's payment terms with Bank were not extended beyond Supplier's invoice due date under its standard payment terms.

Scenario 4: Company C uses P-card in a discount program with the financial institution for normal operating expenditures

Company C, Bank and Supplier have entered into an arrangement whereby Company C can use a P-Card (issued by Bank) to settle amounts due to Supplier at a discounted amount. In addition, Supplier collects the amount due from Bank earlier than it would have received payment from Company C, absent the P-card arrangement. For example, Company C can use the P-card to settle amounts due to Supplier within 10 days of purchase, and in doing so, Bank remits payment to Supplier at 95% of the invoice amount.

Further, Company C has agreed to pay Bank within 90 days of Bank paying Supplier and receives a discount from Bank for earlier payment as follows.

Payment made by Company C to Bank in:	Discount offered by Bank:
< 30 days	2%
31-60 days	1%
61-90 days	0.5%
> 90 days	0%

Company C incurs \$100 of incidental expenditures from Supplier on March 1. The terms of the purchase are net 60. Company C uses the P-card on March 5 to pay for the invoice, and in doing so, Bank remits \$95 to Supplier to settle the amounts due in accordance with the arrangement. Therefore, Company C has extinguished its liability to Supplier and incurred an obligation to Bank.

In this scenario, Company C has received benefits (i.e. ability to settle amounts due to Supplier at a discount if paid in 90 days or less, and the ability to extend payment terms beyond the original invoice due date) that it would not have received without Bank's involvement, indicating the liability may be more of a financing arrangement instead of a convenience to pay for its normal operating purchases. As such, it would not be appropriate for Company C's obligation to Bank to be classified as trade accounts payable.

3.8 Disclosures

3.8.10 Disclosures of debt arrangements under Topic 470



Excerpt from ASC 470-10

> Disclosure of Long-Term Obligations

50-1 The combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings shall be disclosed for each of the five years following the date of the latest balance sheet presented. (See paragraph 505-10-50-11 for related disclosure guidance on redeemable securities). See Example 3 (paragraph 470-10-55-10) for an illustration of this disclosure requirement.

50-2 If an obligation under paragraph 470-10-45-11(b) is classified as a long-term liability (or, in the case of an unclassified balance sheet, is included as a long-term liability in the disclosure of debt maturities), the circumstances shall be disclosed.

• > Example 3: Disclosure of Long-Term Obligations

55-10 This Example provides an illustration of the guidance in paragraph 470-10-50-1 for disclosures for long-term borrowings and preferred stock with mandatory redemption requirements. This Example has the following assumptions.

55-11 Entity D has outstanding two long-term loans, one convertible debt, and one issue of preferred stock with mandatory redemption requirements. The

first loan is a \$100 million sinking fund debenture with annual sinking fund payments of \$10 million in 19X2, 19X3, and 19X4, \$15 million in 19X5 and 19X6, and \$20 million in 19X7 and 19X8. The second loan is a \$50 million note due in 19X5. The convertible debt has a principal amount of \$70 million that is not convertible before maturity in 19X9. This convertible debt requires a 2 percent annual cumulative sinking fund payment of \$1.4 million until settled. The \$30 million issue of preferred stock requires a 5 percent annual cumulative sinking fund payment of \$1.5 million until retired

55-12 Entity D's disclosure might be as follows.

Maturities and sinking fund requirements on long-term loans and convertible debt and sinking fund requirements on preferred stock subject to mandatory redemption are as follows (in thousands).

	Long-term loans	Preferred stock	Convertible debt
19X2	\$ 10,000	\$ 1,500	\$ 1,400
19X3	10,000	1,500	1,400
19X4	10,000	1,500	1,400
19X5	65,000	1,500	1,400
19X6	15,000	1,500	1,400

> Subjective Acceleration Clauses

50-3 As indicated in paragraph 470-10-45-2, in some situations long-term debt subject to a **subjective acceleration clause** shall be reclassified. That paragraph explains that other situations would indicate only disclosure of the existence of such clauses. That paragraph states further that neither reclassification nor disclosure is required if the likelihood of the acceleration of the due date is remote, such as when the lender historically has not accelerated due dates of loans containing similar clauses and the financial condition of the borrower is strong and its prospects are bright.

> Short-Term Obligations Expected to Be Refinanced

50-4 If a short-term obligation is excluded from current liabilities pursuant to the provisions of this Subtopic, the notes to financial statements shall include a general description of the financing agreement and the terms of any new obligation incurred or expected to be incurred or equity securities issued or expected to be issued as a result of a refinancing.

> Summary Disclosure of Securities Outstanding

50-5 Paragraph 505-10-50-3 requires that an entity explain, in summary form within its financial statements, the pertinent rights and privileges of various securities outstanding.

> Unused Commitments and Lines of Credit

Pending Content

Transition Date: (P) June 30, 2027; (N) June 30, 2027 | Transition Guidance: 105-10-65-7

50-6 An entity shall separately disclose the following in the notes to financial statements:

- a. The amount and terms of unused commitments for long-term financing arrangements (including commitment fees and the conditions under which commitments may be withdrawn)
- b. The amount and terms of unused lines of credit for short-term financing arrangements (including commitment fees and the conditions under which lines may be withdrawn) and the amount of those lines of credit that support commercial paper borrowing arrangements or similar arrangements.

> Weighted-Average Interest Rate on Short-Term Borrowings

50-7 A public business entity shall disclose the weighted-average interest rate on short-term borrowings outstanding as of the date of each balance sheet presented.



Excerpt from ASC 470-30

50-1 The borrower's financial statements shall disclose both of the following:

- a. The aggregate amount of participating mortgage obligations at the balance sheet date, with separate disclosure of the aggregate participation liabilities and related debt discounts
- b. Terms of the participations by the lender in either the appreciation in the **fair value** of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or both.

A debtor is required to make the following disclosures related to its debt arrangements classified as noncurrent (excluding participating mortgage obligations).

- Aggregate amount of maturities and sinking fund requirements for each of the five years following the reporting date. [470-10-50-1]
- The circumstances of any debt classified as noncurrent because it is probable that the debtor will cure any covenant violations during the grace period (see section 3.6.40). [470-10-50-2]
- The existence of any subjective acceleration clauses, unless the likelihood of acceleration of a debt's due date is remote – e.g. the creditor historically has not accelerated due dates of debt containing similar clauses and the debtor has a strong financial condition and bright prospects (see section 3.6.10). [470-10-50-3]
- A general description of a financing agreement used to classify a short-term obligation as noncurrent and the terms of any new obligation incurred or expected to be incurred as a result of the financing agreement (see section 3.6.20). [470-10-50-4]

A debtor with participating mortgage obligations is required to make the following disclosures.

- Aggregate amount of participating mortgage obligations with separate disclosure of the aggregate participation liabilities and related debt discounts. [470-30-50-1(a)]
- Terms of the participations by the creditor. [470-10-50-1(b)]



Question 3.8.10

Does Subtopic 470-10 require disclosures related to debt classified as current?

Interpretive response: No. The disclosure requirements in Subtopic 470-10 relate to debt classified as noncurrent. The Subtopic contains no disclosure requirements concerning debt classified as current, including when this classification is due to a covenant violation (see section 3.6.40). However, we believe that an entity should disclose information about a covenant violation and the adverse consequences of probable future noncompliance with a covenant.



Question 3.8.20

What disclosures are required when a creditor waives a covenant violation or loses its right to demand payment?

Interpretive response:

SEC registrants

An SEC registrant must disclose the amount of the obligation for which a covenant violation has occurred and the period of a waiver in which the creditor waives its right to call the debt. [Reg S-X Rule 4-08(c)]

Further, an SEC registrant should consider discussing its debt covenants in MD&A. It is required to discuss and analyze material covenants related to its outstanding debt in at least the following two circumstances. [SEC Release 33-8350.IV.C]

- If it is, or is reasonably likely to be, in violation of a debt covenant (or subject to mandatory prepayment provisions or put rights), the registrant must disclose the breach and analyze its effect, if material. It must disclose items such as steps it takes to avoid or cure a violation, the reasonably likely effect of the violation, and alternative sources of funding.
- If covenants limit (or are reasonably likely to limit) the registrant's ability to take on future financing to a material extent, it is required to discuss the covenant and the consequences of the limitation to financial condition and operating performance.

Non-SEC registrants

Subtopic 470-10 does not specify disclosures for debt covenant violations existing at the reporting date that have been waived by the creditor for a limited

time. Nevertheless, non-SEC registrants should consider disclosing existing violations and the waiver period.

Even if a debt is not callable because of a waiver, information about why the covenant violation occurred would be relevant to financial statement users. Such relevant information could include (if applicable) that the covenant violations resulted from nonpayment of principal or interest on the debt or from the inability to maintain required financial ratios or other financial covenants. This interpretation is consistent with the nonauthoritative guidance contained in TQA 3200.17, *Disclosure of Covenant Violation and Subsequent Bank Waiver*.



Question 3.8.30

What disclosures are required when a violation occurs after the balance sheet date but before the financial statements are issued?

Interpretive response: If a debtor violates a covenant after the reporting date but before issuing the financial statements, it:

- classifies the debt as a noncurrent liability, assuming the debt is a noncurrent liability absent the covenant violation (see section 3.6.10); and
- discloses the violation (including the adverse and legal consequences) in subsequent events note to the financial statements under the requirements of Topic 855.

SEC registrants

If the debtor is an SEC registrant, it follows the guidance in paragraph 855-10-S99-2 to determine when its financial statements are deemed issued. That guidance states the following.



Excerpt from ASC 855-10

> SEC Staff Guidance

• > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings

•• > SEC Staff Announcement: Issuance of Financial Statements

S99-2...

Generally, the staff believes that financial statements are "issued" as of the date they are distributed for general use and reliance in a form and format that complies with generally accepted accounting principles (GAAP) and, in the case of annual financial statements, that contain an audit report that indicates that the auditors have complied with generally accepted auditing standards (GAAS) in completing their audit. Issuance of financial statements then would generally be the earlier of when the annual or quarterly financial statements are widely distributed to all shareholders and other financial statement users FN4 or filed with the Commission. Furthermore, the issuance of an earnings release does

not constitute issuance of financial statements because the earnings release would not be in a form and format that complies with GAAP and GAAS.

FN4 Posting financial statements to a registrant's web site would be considered wide distribution to all shareholders and other financial statement users if the registrant uses its web site to disclose information to the public in a manner consistent with the requirements of Regulation FD. See the Commission's interpretive guidance in Exchange Act Release No. 58288 (Aug. 7, 2008).

Because the covenant violation did not exist as of the reporting date, the registrant is not required to disclose the facts of the covenant violation or the amount of the liability subject to recall as a result of the violation. However, the registrant should consider discussing the violation in MD&A. [\[235-10-S99-1\(c\)\]](#)

3.8.20 Disclosures of obligations from joint and several liability arrangements under Topic 405-40



Excerpt from ASC 405-40

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

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

50-2 The disclosures required by this Section do not affect the related-party disclosure requirements in Topic 850. The disclosure requirements in this Section are incremental to those requirements.

A debtor with joint and several liability arrangements is required to make the following qualitative and quantitative disclosures for each obligation, or each group of similar obligations.

Qualitative disclosures	Quantitative disclosures
<p>Nature of the debtor’s arrangement, including: [405-40-50-1(a)]</p> <ul style="list-style-type: none"> — how the liability arose; — relationship with other co-obligors; and — terms and conditions of the arrangement. 	<p>Outstanding amount, ignoring any amounts that may be recoverable from other entities. [405-40-50-1(b)]</p>
<p>Nature of any recourse provisions that would enable recovery from other entities of the amounts paid, including any limitations on the amounts that might be recovered. [405-40-50-1(d)]</p>	<ul style="list-style-type: none"> — Carrying amount, if any, of the debtor’s liability — Carrying amount of any receivable recognized, and where recorded on the balance sheet.¹ [405-40-50-1(c), 50-1(e)]
<p>Note:</p> <p>1. Disclosure of the liability and receivable’s presentation is only required in the period the amount is initially recognized or in a period the measurement changes.</p>	

3.8.30 Disclosures of supplier finance obligations under Subtopic 405-50



Excerpt from ASC 405-50

05-1 This Subtopic addresses the disclosures applicable for an entity that uses a supplier finance program in connection with the purchase of goods and services (the buyer in a supplier finance program). A supplier finance program also may be referred to as a reverse factoring, payables finance, or structured payables arrangement.

10-2 This Subtopic does not address either of the following:

- a. A buyer’s recognition, measurement, or financial statement presentation of an obligation in connection with a supplier finance program
- b. The accounting and disclosure for other parties involved in a supplier finance program.

15-1 The guidance in this Subtopic applies to all entities that use supplier finance programs in connection with the purchase of goods and services (buyers in a supplier finance program).

Subtopic 405-50 requires the buyer in a supplier finance program to make certain disclosures. Without exception, it applies to all entities that are buyers in such a program. [405-10-15-1]

For balance sheet presentation guidance, see section 3.7.70. For statement of cash flows presentation guidance, see section 12.4.10 of KPMG Handbook, [Statement of cash flows](#).



Question 3.8.40

What supplier finance programs are subject to the required disclosures?



Excerpt from ASC 405-50

15-2 The guidance in this Subtopic applies to obligations in connection with supplier finance programs. A supplier finance program is an arrangement that has all the following characteristics:

- a. An entity enters into an agreement with a finance provider or an intermediary.
- b. The entity confirms supplier invoices as valid to the finance provider or intermediary under the agreement described in (a).
- c. The entity's supplier has the option to request early payment from a party other than the entity for invoices that the entity has confirmed as valid.

15-3 Although not determinative, an indicator that an entity may have a supplier finance program is the commitment to pay a party other than the supplier for a confirmed invoice without offset, deduction, or any other defenses to payment.

15-4 In determining whether an entity has established a supplier finance program and, therefore, is subject to the disclosures required by this Subtopic, all available evidence shall be considered, including arrangements between the entity and its finance provider or intermediary and between the entity and its suppliers whose invoices the entity has confirmed as valid to the finance provider or intermediary.

Interpretive response: Subtopic 405-50 does not provide a prescriptive definition of a supplier finance program. Instead, it lists the characteristics of such a program, provides an indicator to determine whether an entity has a supplier finance program, and identifies evidence to consider when evaluating whether an agreement is subject to the Subtopic's disclosure requirements.

Characteristics of a supplier finance program

The following are the three characteristics of a supplier finance program: [\[405-50-15-2\]](#)

- an entity (i.e. the buyer of goods or services) enters into an agreement with a finance provider or an intermediary;
- the buyer purchases goods and services from suppliers with a promise to pay at a later date, and confirms to the finance provider or intermediary the supplier invoices that are valid (i.e. eligible for payment); and

- the buyer’s supplier has the option to request early payment from the finance provider or intermediary for the ‘validated’ invoices.

In a supplier finance program, the finance provider or intermediary typically settles the validated invoices with the buyer’s suppliers first. Then, at a later date (e.g. the date the buyer is obligated to pay the supplier), the buyer pays the invoice amounts to the finance provider or intermediary.


Indicator that an arrangement is a supplier finance program

Subtopic 405-50 describes supplier finance programs more generally with an indicator to help preparers identify the arrangements that require disclosure. The indicator that the buyer has established a supplier finance program is the buyer’s commitment to pay a party other than the supplier for a confirmed invoice without offset, deduction, or any other defenses to payment. However, the indicator will not be determinative in all cases because payment processing services often require similar commitments and may not be considered supplier finance programs (see Question 3.8.50). [405-50-15-3]

Evidence to be considered when evaluating an arrangement

In determining whether a buyer has established a supplier finance program, all available evidence is considered, including arrangements: [405-50-15-4]

- between the buyer and a finance provider or an intermediary; and
- between the buyer and its suppliers whose invoices the buyer has confirmed as valid to the finance provider or intermediary.

 **Question 3.8.50**
What are some examples of arrangements that are not in scope of the disclosures?

Interpretive response: The following table includes examples of types of arrangements that do not represent supplier finance programs subject to the disclosure requirements.

Type of arrangement	Description	Reason(s) arrangement is not in scope
Traditional credit card arrangements [including p-cards]	Traditional credit card arrangements are established between an entity (the buyer) and a finance provider. The buyer purchases goods or services from its suppliers and pays for those with a credit card. The finance provider then pays the amount owed by the buyer directly to the supplier and the buyer settles its obligations with the finance provider at a later date. A p-card is a form of a corporate credit card that allows a buyer to make electronic payments for	These arrangements do not allow suppliers the option to request early payment from the finance provider, which is a characteristic necessary for a supplier finance program (see Question 3.8.40). Instead, the buyer directs the finance provider to pay the supplier. [ASU 2022-04.BC18]

Type of arrangement	Description	Reason(s) arrangement is not in scope
	business expenditures owed to a supplier (see section 3.7.80).	
'Normal' payment processing arrangements	Normal payment processing arrangements are established between an entity (the buyer) and an intermediary. The intermediary processes invoices on the buyer's behalf as its outsourced agent, including making payments for the invoices to the buyer's suppliers.	These arrangements do not allow suppliers the option to request early payment from the intermediary, which is a characteristic necessary for a supplier finance program (see Question 3.8.40). Instead, the buyer directs the intermediary to pay the supplier. [ASU 2022-04.BC18]
'Normal' factoring arrangements	Normal factoring arrangements are established between the buyer's supplier and the supplier's finance provider (factor). Under these arrangements, the factor agrees to purchase the supplier's accounts receivables (i.e. the amounts owed by the buyer) for a fee.	The buyer of goods and services does not enter into an agreement with the finance provider, which is a characteristic necessary for a supplier finance program (see Question 3.8.40). [ASU 2022-04.BC18]



Question 3.8.60

Are supplier finance programs excluded from the required disclosures if the related obligations are presented as debt instead of accounts payable?

Interpretive response: No. An arrangement that meets the characteristics of a supplier finance program (see Question 3.8.40) is included in the scope of the disclosures regardless of how the buyer presents the obligations on the balance sheet (i.e. whether the obligations are presented as accounts payable or debt). [ASU 2022-04.BC17]



Question 3.8.70

What are the objectives of Subtopic 405-50's disclosure requirements?



Excerpt from ASC 405-50

50-1 The objective of the requirements in this Subtopic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, activity during the period, changes from period to

period, and potential magnitude of the entity's supplier finance programs. To achieve that objective, an entity shall disclose qualitative and quantitative information about its supplier finance programs.

Interpretive response: The objective of the disclosure requirements is for the entity (i.e. buyer) to disclose sufficient information to enable financial statement users to understand the following about its supplier finance programs.

Disclosure objectives [405-50-50-1]

- The nature of the programs;
- Activity during the period;
- Changes from period to period; and
- Potential magnitude.



Question 3.8.80

Can disclosures be provided on an aggregated basis by an entity with more than one supplier finance program?



Excerpt from ASC 405-50

50-2 An entity shall consider the level of detail necessary to satisfy the disclosure objective. If an entity uses more than one supplier finance program, the entity may aggregate disclosures, but not to the extent that useful information is obscured by the aggregation of programs that have substantially different characteristics.

Interpretive response: It depends. The buyer has to carefully consider the level of detail necessary to satisfy the disclosure objective (see Question 3.8.70). Aggregation is permitted if an entity has more than one supplier finance arrangement, but not to the extent that the aggregation obscures useful information about programs that have substantially different characteristics. [405-50-50-2]



Question 3.8.90

What disclosures are required about supplier finance programs in each annual reporting period?



Excerpt from ASC 405-50

50-3 In each annual reporting period, an entity shall disclose all the following information about its supplier finance programs:

- a. The key terms of the program, including, but not limited to:
 - 1. A description of the payment terms, including payment timing and the basis for its determination
 - 2. Assets pledged as security or other forms of guarantees provided for the committed payment to the finance provider or intermediary.

See paragraphs 405-50-55-1 through 55-3 for an illustrative example.
- b. The amount of obligations outstanding at the end of the reporting period that the entity has confirmed as valid to the finance provider or intermediary under the program (that is, the amount of obligations confirmed under the program that remains unpaid by the entity) and the following information about those obligations:
 - 1. Where those obligations are presented in the balance sheet. If those obligations are presented in more than one balance sheet line item, then the entity shall disclose the amount outstanding at the end of the reporting period in each line item.
 - 2. A rollforward of those obligations showing, at a minimum, all the following:
 - i. The amount of those obligations outstanding at the beginning of the reporting period
 - ii. The amount of those obligations added to the program during the reporting period
 - iii. The amount of those obligations settled during the reporting period
 - iv. The amount of those obligations outstanding at the end of the reporting period.

Interpretive response: An entity discloses qualitative and quantitative information about two aspects of its supplier finance programs annually, as explained in the table below. [405-50-50-3]

Disclosure area	Required details
Key terms of the program	Key terms include: <ul style="list-style-type: none"> — a general description of the payment terms (including payment timing and basis for its determination); and

Disclosure area	Required details
	<ul style="list-style-type: none"> — assets pledged as security or other forms of guarantees provided for the committed payment to the finance provider or intermediary.
Obligation amount that the buyer has confirmed as valid to the finance provider or intermediary	<p>Required disclosures regarding this obligation are:</p> <ul style="list-style-type: none"> — the amount outstanding that remains unpaid by the buyer as of the end of the reporting period (the outstanding confirmed amount); — a description of where that amount is presented on the balance sheet (whether presented in accounts payable or in another balance sheet line item), and the amount disclosed in each line item if presented in more than one line; and — a rollforward of the obligations showing the opening balance, the amounts added to the program, the amounts settled under the program and the closing balance.

These disclosures are illustrated in Subtopic 405-50's Examples 1 and 2 (reproduced directly below).



Excerpt from ASC 405-50

> Illustrations

- > Example 1: Disclosure about the Key Terms of a Supplier Finance Program

55-1 Based on the limited facts and hypothetical fact pattern described in paragraph 405-50-55-2, this Example illustrates how an entity might apply the guidance in paragraph 405-50-50-3(a) to disclose the key terms of a supplier finance program, including a description of the payment terms (which includes payment timing and basis for its determination) and the assets pledged as security or other forms of guarantees provided for the committed payment to the finance provider or intermediary. This Example is not intended to illustrate every aspect of the key terms of a program that should be disclosed by a buyer entity. Identifying the key terms of a supplier finance program is a matter of judgment, based upon the facts of the arrangement.

55-2 Entity A enters into a supplier finance program with Bank B in which Entity A agrees to pay Bank B on the invoice maturity dates the stated amount of invoices that Entity A has confirmed on Bank B's supplier finance platform. Entity A pays Bank B an annual subscription fee for the supplier finance platform and a service fee for related support. Entity A or Bank B may terminate the agreement upon at least 90 days' notice. The agreement with Bank B does not require that Entity A provide assets pledged as security or other forms of guarantees for the supplier finance program. Bank B does not advise Entity A of the maximum size of the program. Bank B also enters into a separate arrangement with Entity A's suppliers and provides them with the option to request early payment from Bank B 9 for invoices confirmed by Entity A. Entity A does not determine the terms or conditions of the arrangement

between Bank B and Entity A's suppliers. Entity A does not participate in the transactions between its suppliers and Bank B. The supplier invoices that have been confirmed as valid under the program require payment in full within 90 days of the invoice date.

55-3 Entity A determined that it should disclose the following information on the key terms of its supplier finance program:

Under a supplier finance program, Entity A agrees to pay a bank the stated amount of confirmed invoices from its designated suppliers on the original maturity dates of the invoices, an annual subscription fee for the supplier finance platform, and service fees for related support. Entity A or the bank may terminate the agreement upon at least 90 days' notice. The supplier invoices that have been confirmed as valid under the program require payment in full within 90 days of the invoice date.

• > Example 2: Disclosure of a Rollforward of Obligations Confirmed as Valid under a Supplier Finance Program

55-4 This Example provides an illustration of the guidance in paragraph 405-50-50-3(b)(2) based on the assumptions that Entity A provides one comparative balance sheet and that its supplier finance program is denominated in Entity A's reporting currency.

55-5 The following illustrates the disclosures in a tabular format.

The rollforwards of Entity A's outstanding obligations confirmed as valid under its supplier finance program for years ended December 31, 20X2, and 20X1, are as follows (in thousands):

	<u>20X2</u>	<u>20X1</u>
Confirmed obligations outstanding at the beginning of the year	\$ 733	\$ 712
Invoices confirmed during the year	2,435	2,278
Confirmed invoices paid during the year	<u>(2,315)</u>	<u>(2,257)</u>
Confirmed obligations outstanding at the end of the year	<u>\$ 853</u>	<u>\$ 733</u>



Question 3.8.100

What disclosures are required about supplier finance programs in each interim reporting period?



Excerpt from ASC 405-50

50-4 In each interim reporting period, an entity shall disclose the amount of

obligations outstanding that the entity has confirmed as valid to the finance provider or intermediary under the supplier finance program at the end of the reporting period.

Interpretive response: An entity discloses the outstanding obligation amount confirmed as valid at the end of each interim reporting period. [\[405-50-50-4\]](#)

However, during the year of adoption, the entity also is required to disclose the information about the key terms of the programs and the balance sheet presentation (see Question 3.8.90) in each interim period, even though this information is required to be disclosed only annually thereafter. [\[405-50-65-1\(c\)\]](#)

4. TDRs, debt modifications and extinguishments

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Item significantly updated in this edition: #
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- 4.4.21 Is an exchange of convertible debt for convertible preferred shares treated as an extinguishment? ^^
- 4.4.30 How does a debtor determine whether the terms are substantially different?
- 4.4.40 What factors are relevant when a conversion option or other feature in the original debt instrument is separately recognized as a derivative? #
- 4.4.50 How are the 'substantially different' analyses performed for convertible debt with a separately recognized equity component?
- 4.4.60 What factors does a debtor consider when performing the cash flow test?
- 4.4.70 How do fees paid to third parties affect the cash flow test?

4. TDRs, debt modifications and extinguishments

- 4.4.80 Does a debtor treat the creditor's costs that the debtor pays directly to third parties as fees paid to the creditor or to third parties?
- 4.4.90 How many cash flow analyses does the debtor perform when a prepayment option exists?
- 4.4.100 Does the debtor's financial inability to exercise a prepayment option affect the cash flow test?
- 4.4.110 How does a contingently exercisable prepayment option affect the cash flow test?
- 4.4.120 Between the gross and net methods, is one preferred over the other?
- 4.4.130 When are cash flows associated with an increase or decrease in principal included in the cash flow test?
- 4.4.140 How is the cash flow test applied when the debt instruments are denominated in the same foreign currency?
- 4.4.150 How is the cash flow test applied when the original and new debt instruments are denominated in different currencies?
- 4.4.160 Do noncash changes to a debt agreement affect the cash flow test?
- 4.4.170 Does the modification of a debt instrument designated in a cash flow or fair value hedging relationship automatically terminate the existing hedging relationship?
- 4.4.180 How is a debt accounted for when it is repaid with proceeds from the issuance of new debt?
- 4.4.190 Is a debt restructuring subject to the guidance on modifications and exchanges when old debt is repaid with proceeds from issuance of new debt?

Examples

- 4.4.10 Modification of debt instrument is substantial – no prepayment feature
- 4.4.20 Modification of debt instrument is not substantial – no prepayment feature
- 4.4.30 Modification of a debt instrument with prepayment features
- 4.4.40 Separate modifications occurring within a year for the same debt instrument
- 4.4.50 Modification-date cash inflow increases the principal amount – incremental borrowing
- 4.4.60 Modification-date cash outflow decreases the principal amount – partial repayment with no prepayment features
- 4.4.70 Modification-date cash outflow decreases the principal amount – partial repayment under contractual prepayment terms of original borrowing

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- 4.4.80 Modification-date cash outflow decreases the principal amount – partial repayment not under the contractual prepayment terms of original borrowing
- 4.4.90 Modification-date cash outflow significantly decreases the principal amount – partial repayment when use of net method may be appropriate
- 4.4.100 Modification of a debt instrument designated in a hedging relationship

4.5 Extinguishment accounting for non-TDR debt restructurings

- 4.5.10 Extinguishment accounting (general model)
- 4.5.20 Extinguishment accounting for convertible debt
- 4.5.30 Accounting for fees and issuance costs when extinguishment accounting is applied
- 4.5.40 Fees and costs paid in anticipation of a debt amendment or restructuring

Questions

- 4.5.10 How does a debtor account for a modification or exchange when extinguishment accounting applies?
- 4.5.20 How does the debtor recognize and present the gain or loss on extinguishment? #
- 4.5.30 When a debt extinguishment gain or loss is recognized in the income statement, can it be presented as interest expense? #
- 4.5.40 Does extinguishment accounting for convertible instruments differ based on their nature and type? #
- 4.5.50 How does a debtor apply extinguishment accounting when convertible debt is modified or exchanged? #
- 4.5.60 [Not used]
- 4.5.70 How does a debtor account for fees related to a debt modification when extinguishment accounting is applied?
- 4.5.75 How does a debtor account for a modification or exchange of a freestanding equity-classified written call option associated with a debt modification under extinguishment accounting?
- 4.5.80 How are fees and costs accounted for if the related specific debt amendment or restructuring does not occur by the end of the reporting period?

Examples

- 4.5.10 Applying extinguishment accounting in a substantial modification
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4. TDRs, debt modifications and extinguishments

- 4.5.30 [Not used]
- 4.5.40 [Not used]
- 4.5.50 [Not used]
- 4.5.60 Partial forgiveness of debt by a parent – capital transaction
- 4.5.70 Share settlement of debt in a related-party transaction
- 4.5.80 Share settlement of a note payable – not a related party transaction
- 4.5.90 Convertible note payable exchanged for convertible preferred shares

4.6 Modification accounting for non-TDR debt restructurings

- 4.6.10 Modification accounting (general model)
- 4.6.20 Modification accounting for convertible debt
- 4.6.30 Accounting for fees and issuance costs when modification accounting is applied

Questions

- 4.6.10 What is the accounting treatment for a modification of nonconvertible debt?
- 4.6.20 What is the accounting treatment for a modification of convertible debt?
- 4.6.30 [Not used]
- 4.6.40 How does a debtor account for fees and costs related to a debt modification under modification accounting?
- 4.6.45 How does a debtor account for a modification or exchange of a freestanding equity-classified written call option associated with a debt modification under modification accounting?
- 4.6.50 How does a debtor classify in the income statement third-party costs incurred for a modification that is not substantial?
- 4.6.60 How are modification fees paid to a creditor as part of an equity offering accounted for?

Examples

- 4.6.10 Applying modification accounting when a modification is not substantial
- 4.6.20 Applying modification accounting (with incremental borrowing) when a modification is not substantial
- 4.6.30 Modification of a convertible debt instrument when extinguishment accounting is not applied

4.7 Non-TDR debt restructurings involving a loan participation or loan syndicate

4.7.10 Transactions with third-party intermediaries

Questions

4.7.10 If a creditor withdraws from a syndicate in connection with a debt restructuring, is the debt instrument held by the withdrawing creditor extinguished?

4.7.20 If a debt restructuring involves multiple debt instruments with the same creditor or creditor group, are the cash flows analyzed individually or on a consolidated basis?

4.7.30 How are third-party intermediaries considered when determining whether a modification or exchange of a debt instrument is an extinguishment?

4.7.40 How are fees paid to intermediaries for debt modifications accounted for?

Example

4.7.10 Modification of a revolving debt facility, including a change in composition of the bank syndicate

4.8 Non-TDR debt restructurings of line-of-credit or revolving-debt arrangements

Questions

4.8.10 Does the guidance in paragraph 470-50-40-21 apply when either the old or the new instrument is term debt?

4.8.20 Does the 'borrowing capacity' refer to the funds available to the debtor?

4.8.30 How does a debtor account for a modification or exchange of a freestanding equity-classified written call option associated with a modified or exchanged line-of-credit or revolving-debt arrangement?

Examples

4.8.10 Modification of revolving credit facility (increase in borrowing capacity)

4.8.20 Modification of revolving credit – decrease in borrowing capacity

4.8.30 Modification of revolving credit facility – exchange with term loan

4.9 Non-TDR restructurings of auction rate securities**Questions**

- 4.9.10 How is prepaid bond insurance accounted for when it relates to an ARS that has been restructured?
- 4.9.20 How does a mandatory tender option affect the characterization of a restructured ARS?

4.10 Extinguishments of debt instruments and other liabilities (other than debt restructurings)

- 4.10.10 Extinguishment of debt instruments and other liabilities (general model)
- 4.10.20 Extinguishments of convertible debt instruments
- 4.10.30 Situations that do not result in debt extinguishment

Questions

- 4.10.10 Does the transfer of collateral to a creditor extinguish the debt?
- 4.10.15 Does a debtor account for a third party's agreement to pay its debt as an extinguishment of that debt? **
- 4.10.16 Does an entity derecognize a liability if it has insurance to cover the loss? **
- 4.10.20 Are management's intentions evaluated in determining debt extinguishment?
- 4.10.25 Does an issuer recognize an asset when it purchases 'treasury bonds' if it intends to resell them?
- 4.10.30 How does an entity allocate a single payment made to settle both its debt and repurchase its own equity?
- 4.10.40 What is the accounting treatment for an extinguishment of a convertible debt instrument that has no proceeds allocated to the conversion feature?
- 4.10.50 What is the accounting treatment for an extinguishment of a convertible instrument with a bifurcated conversion feature?
- 4.10.60 What is the accounting treatment for an extinguishment of a convertible instrument with a bifurcated conversion feature that was subsequently reclassified to equity?
- 4.10.70 What is the accounting treatment for an extinguishment of a convertible instrument with bifurcated derivatives other than a conversion option?
- 4.10.80 What is the accounting treatment for an extinguishment of a convertible debt instrument issued at a substantial premium?
- 4.10.90 [Not used]
- 4.10.100 [Not used]

4. TDRs, debt modifications and extinguishments

- 4.10.110 Is there a difference in applying derecognition accounting for an in-substance defeasance compared to a legal defeasance?
- 4.10.120 How is a secondary offering or related exchange that enables a debtor to exchange unregistered debt securities for registered debt securities accounted for under Subtopic 470-50?

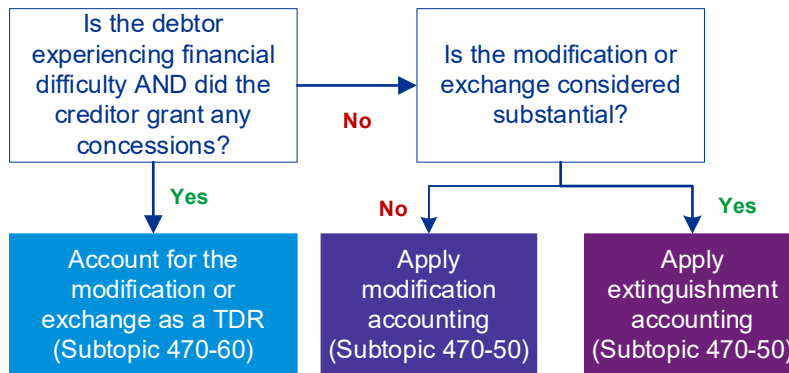
Examples

- 4.10.10 Extinguishing debt by transferring collateral to the creditor
- 4.10.11 Extinguishment through prepayment of note payable – loss on extinguishment ^^
- 4.10.12 Partial extinguishment through reacquisition of bonds in the market – loss on extinguishment ^^
- 4.10.13 Accounting for a premium to prepay a portion of the principal balance on a term loan – loss on extinguishment ^^
- 4.10.20 Debtor released as primary obligor but still guarantees the debt
- 4.10.25 Purchase of parent's debt securities by a broker-dealer subsidiary
- 4.10.30 Advanced bond refunding (debt defeasance)
- 4.10.40 Reacquisition of convertible bonds in the market
- 4.10.50 [Not used]
- 4.10.60 Announcement of intent to repurchase debt that is subject to a prepayment penalty
- 4.10.70 Exchange of unregistered debt securities for registered debt securities

4.1 How the standard works

This chapter covers the accounting for a troubled debt restructuring (TDR), other debt modifications and extinguishments of liabilities, including convertible debt instruments. A modification or exchange of a debt instrument is called a 'debt restructuring' in this chapter.

A standard debt extinguishment, where there is no modification or refinancing, is accounted for under Subtopic 405-20. Complexity arises when a debt is modified or exchanged for new debt with the same lenders. How a modification or exchange of debt with the same lenders is accounted for is illustrated in the following decision tree.



Modification accounting under Subtopic 470-50 contains two accounting models:

- nonconvertible debt – which includes mandatorily redeemable preferred shares that are classified as a liability under Topic 480 – and convertible debt model; and
- line-of-credit and revolving-debt arrangement model.

Subtopic 470-50 does not provide guidance on the derecognition of convertible debt that is converted into equity under an instrument's original conversion terms or induced conversions. Instead, such conversions are accounted for under Subtopic 470-20 and are addressed in chapter 10.



Observation

Optional expedients available in Subtopic 848-20 for debt modifications

The guidance in this chapter does not consider the optional expedients that may be available in Subtopic 848-20 (reference rate reform – contract modifications) for contracts (including debt instruments) that are modified in connection with transitioning away from LIBOR and other reference rates that are expected to be discontinued.

If a debt modification is eligible for the expedients in Subtopic 848-20, an entity can:

- account for the modification as a continuation of the existing debt without additional analysis; and
- consider embedded features to be clearly and closely related to the host contract without reassessment.

To be eligible for these expedients, the debt instrument being modified must generally reference LIBOR or another rate that is expected to be discontinued. Further, the modification must generally consist only of changes to the debt instrument's terms that are related to replacement of the reference rate.

If a debt modification is not eligible for – or if an issuer does not elect to apply – the expedients in Subtopic 848-20, it is evaluated based on the guidance in this chapter.

Chapter 3 of KPMG Handbook, [Reference rate reform](#), provides additional information about Subtopic 848-20's contract modification optional expedients.

4.2 Identifying a TDR

4.2.10 Overview



Excerpt from ASC 470-60

05-1 This Subtopic addresses measurement, derecognition, disclosure, and implementation guidance issues concerning **troubled debt restructurings** focused on the debtor's records.

10-1 The accounting for restructured debt is based on the substance of the modifications—the effect on cash flows—not on the labels chosen to describe those cash flows. The substance of all modifications of a debt in a **troubled debt restructuring** is essentially the same whether they involve modifications of any of the following:

- a. Timing
- b. Amounts designated as interest
- c. Amounts designated as face amounts.

10-2 All of those kinds of modifications affect future cash receipts or payments and therefore affect both of the following:

- a. The creditor's total return on the receivable, its effective interest rate, or both
- b. The debtor's total cost on the payable, its effective interest rate, or both.



Question 4.2.10

When does a debtor analyze Subtopic 470-60 to determine if a debt restructuring is a TDR?

Interpretive response: If a debt instrument has been modified or exchanged with the same lender, the debtor first applies Subtopic 470-60 to determine if the transaction is a TDR. If the modification or exchange does not meet the criteria for a TDR or is not with the same lender, then Subtopic 470-50 applies (see section 4.4). [470-50-15-3(b)]

4.2.20 Scope of Subtopic 470-60



Excerpt from ASC 470-60

20 Glossary

Troubled Debt Restructuring

A restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

> Entities

15-1 The guidance in this Subtopic applies to all debtors.

> Transactions

15-2 The guidance in this Subtopic applies to all **troubled debt restructurings** by debtors.

• > Troubled Debt Restructuring

15-10 The guidance in this Subtopic shall be applied to all troubled debt restructurings including those consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other federal statutes related thereto. This Subtopic does not apply, however, if under provisions of those federal statutes or in a quasi-reorganization or corporate readjustment (see Topic 852) with which a troubled debt restructuring coincides, the debtor restates its liabilities generally, that is, if such restructurings or modifications accomplished under purview of the bankruptcy court encompass most of the amount of the debtor's liabilities.

15-11 For purposes of this Subtopic, none of the following are considered troubled debt restructurings:

- a. **Lease modifications** (for guidance, see Topic 842)
- b. Changes in employment-related agreements, for example, pension plans and deferred compensation contracts
- c. Unless they involve an agreement between debtor and creditor to restructure, neither of the following:
 1. Debtors' failures to pay trade accounts according to their terms
 2. Creditors' delays in taking legal action to collect overdue amounts of interest and principal.

> Implementation Guidance

• > Applicability of This Subtopic to Entities in Chapter 11 Bankruptcy

55-1 Entities involved with Chapter 11 bankruptcy proceedings frequently reduce all or most of their indebtedness with the approval of their creditors and the court in order to provide an opportunity for the entity to have a fresh start. Such reductions are usually by a stated percentage so that, for example, the debtor owes only 60 cents on the dollar. Because the debtor would be restating its liabilities generally, this Subtopic would not apply to the debtor's accounting for such reduction of liabilities.

55-2 On the other hand, this Subtopic would apply to an isolated **troubled debt restructuring** by a debtor involved in bankruptcy proceedings if such restructuring did not result in a general restatement of the debtor's liabilities.

Subtopic 470-60 applies to TDRs, which are defined as a debt restructuring in which the creditor grants a concession to the debtor because the debtor is having financial difficulties. The criteria for determining whether a restructuring meets this definition is detailed in section 4.2.40. [[470-60-15-2](#), [470-60 Glossary](#)]

**Question 4.2.20#****When is a debt instrument or contract outside the scope of Subtopic 470-60?**

Interpretive response: The following types of debt and other instruments are outside the scope of Subtopic 470-60, and therefore restructurings of such instruments are not accounted for as TDRs.

Scope exceptions

Debt reported at fair value in earnings under the fair value option in Subtopic 825-10.

Debt restructured as part of a reorganization under federal statutes (bankruptcy and Topic 852 (reorganizations)) where the majority of the debtor's liabilities are modified. See KPMG Handbook, [Accounting for bankruptcies](#). [470-60-55-1 – 55-2]

Lease modifications. See KPMG Handbook, [Leases](#). [470-60-15-11]

Changes in employment-related agreements (e.g. pension plans, deferred compensation contracts). [470-60-15-11]

Unless it involves an agreement between debtor and creditor to restructure, neither of the following: [470-60-15-11]

- debtor's failures to pay trade accounts according to their terms, or
- creditor's delays in taking legal action to collect overdue amounts of interest and principal.

Changes within investment-grade credit ratings. For example, debt was investment grade (AAA) before the modification and investment grade (BBB) after the modification. In our experience, unless the debt is publicly traded, this scope exception is difficult to support. See Question 4.2.60.

4.2.30 Unit of account**Excerpt from ASC 470-60**

- > Unit of Accounting

15-4 The substance rather than the form of the payable shall govern. Payables that may be involved in troubled debt restructurings commonly result from borrowing of cash, or purchasing goods or services on credit. Examples are accounts payable, notes, debentures and bonds (whether those payables are secured or unsecured and whether they are convertible or nonconvertible), and related accrued interest, if any. Typically, each payable is negotiated separately, but sometimes two or more payables are negotiated together. For example, a debtor may negotiate with a group of creditors but sign separate debt instruments with each creditor. For purposes of this Subtopic, restructuring of each payable, including those negotiated and restructured jointly, shall be accounted for individually.

15-4A In this Subtopic, a receivable or a payable (collectively referred to as debt) represents a contractual right to receive money or a contractual obligation to pay money on demand or on fixed or determinable dates that is already included as an asset or a liability in the creditor's or debtor's balance sheet at the time of the restructuring.

- > Unit of Accounting

55-3 To a debtor, a bond constitutes one payable even though there are many bondholders.



Question 4.2.30

What is the appropriate unit of account when analyzing if a debt restructuring is a TDR?

Interpretive response: All debt instruments from one creditor are generally included in the same unit of account. This is true even if there are multiple creditors and the debt instruments or similar contracts are renegotiated with all the creditors together; each creditor relationship is analyzed separately under Subtopic 470-60. However, a debtor determines the first criterion for a TDR (i.e. whether the debtor is experiencing financial difficulties) on an entity-wide basis (see section 4.2.50). Section 4.3.60 addresses evaluating multiple loans. [470-60-15-4]

4.2.40 TDR criteria



Excerpt from ASC 470-60

- > Troubled Debt Restructuring

15-5 A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Subtopic if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

15-6 That concession is granted by the creditor in an attempt to protect as much of its investment as possible. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court; for example, either of the following circumstances might occur:

- A creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor.
- The creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the

amount of the debt because the creditor concludes that step will maximize recovery of its investment.

Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term troubled debt restructuring in this Subtopic.

15-7 Whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it.

15-8 In general, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. A debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor in the troubled debt restructuring, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them.

15-9 A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

- a. Transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession)
- b. Issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest
- c. Modification of terms of a debt, such as one or a combination of any of the following:
 1. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt
 2. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk
 3. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement
 4. Reduction (absolute or contingent) of accrued interest.

15-12 A debt restructuring is not necessarily a troubled debt restructuring for purposes of this Subtopic even if the debtor is experiencing some financial difficulties. For example, a troubled debt restructuring is not involved if any of the following circumstances exist:

- a. The **fair value** of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's **amortized cost basis** in the receivable.
- b. The fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable.
- c. The creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate.

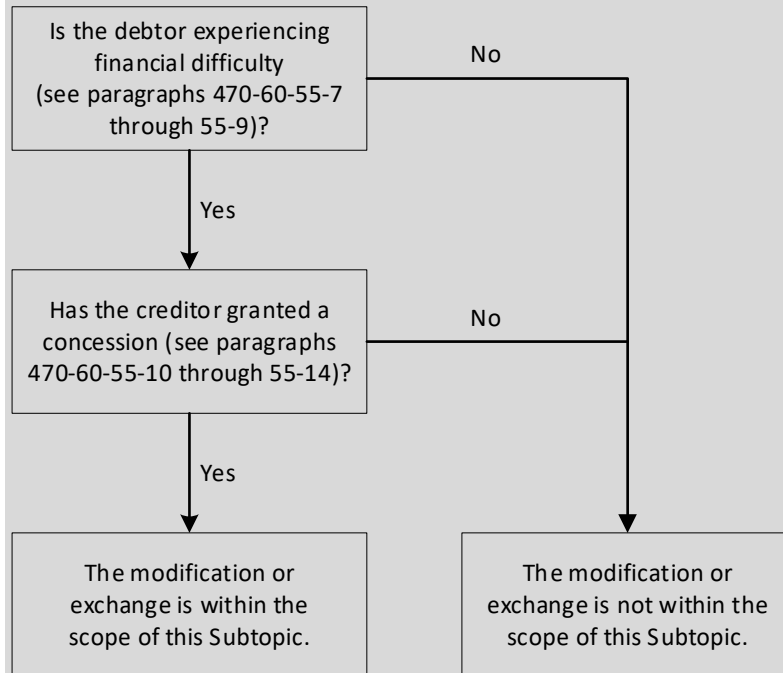
- d. The debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors.

15-13 For further guidance on determining whether a modification or exchange is a troubled debt restructuring, see paragraphs 470-60-55-4 through 55-7. If a debtor concludes that the modification or exchange is not within the scope of this Subtopic, the debtor would apply the provisions of Subtopic 470-50.

- > Distinguishing Between a Troubled Debt Restructuring and a Modification or Exchange

55-4 No single characteristic or factor, taken alone, is determinative of whether a modification or exchange is a troubled debt restructuring under this Subtopic. That is, the fact that a single characteristic is present in a transaction (such as that described in paragraph 470-60-15-9(c)(3) or 470-60-15-12(d)) should not be considered sufficient to overcome the preponderance of contrary evidence. Determining whether a transaction is within the scope of this Subtopic requires the exercise of judgment. The guidance that follows is not limited to marketable debt instruments.

55-5 The following model should be applied by a debtor when determining whether a modification or an exchange of debt instruments is within the scope of this Subtopic.





Question 4.2.40

What are the criteria for a restructuring to be considered a TDR?

Interpretive response: A TDR is a debt restructuring in which the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. [470-60 Glossary]

Criteria for a TDR	
An exchange or modification of debt is considered to be a TDR if both criteria are met:	The debtor is experiencing financial difficulty. This analysis is performed on an entity-wide basis. [470-60-55-8] See section 4.2.50.
	For economic or legal reasons, a creditor grants a concession to a debtor that it would not otherwise consider. This analysis is performed by the debtor on a creditor-by-creditor basis and considers all payables with the creditor. [470-60-15-4] See section 4.2.60.
Determining whether an exchange or modification of debt is a TDR requires judgment and depends on the facts and circumstances. No single characteristic or factor, taken alone, determines whether a modification or exchange is a TDR. [470-60-55-4]	



Question 4.2.50

What guidance applies in determining whether a debtor is experiencing financial difficulty or was granted a concession by the creditor?

Interpretive response: Section 470-60-55 contains implementation guidance on how to determine whether a debtor is experiencing financial difficulties and whether a creditor has granted a concession. That implementation guidance seems to contradict guidance in other sections of Subtopic 470-60 in certain cases – e.g. paragraph 470-60-15-9 indicates that a reduction of the stated interest rate for the remaining original life of the debt may be a TDR; however, paragraph 470-60-55-9 indicates that may not necessarily be indicative that the debtor is experiencing financial difficulties (see section 4.2.50). Nevertheless, Section 470-60-55 contains the requirements to make those determinations.

Therefore, even if guidance in other sections of the Subtopic appears contradictory, we believe the guidance in Section 470-60-55 applies when making those determinations.

4.2.50 Debtor is experiencing financial difficulties criterion



Excerpt from ASC 470-60

- • > Determining Whether the Debtor Is Experiencing Financial Difficulties

55-7 If the debtor's creditworthiness (for example, based on its credit rating or equivalent, the effects of the original collateral or credit enhancements in the debt, or its sector risk) has deteriorated since the debt was originally issued, the debtor should evaluate whether it is experiencing financial difficulties. Changes in an investment-grade credit rating are not considered a deterioration in the debtor's creditworthiness for purposes of this guidance. Conversely, a decline in credit rating from investment grade to noninvestment grade is considered a deterioration in the debtor's creditworthiness for purposes of this guidance.

55-8 All of the following factors are indicators that the debtor is experiencing financial difficulties:

- The debtor is currently in default on any of its debt.
- The debtor has declared or is in the process of declaring bankruptcy.
- There is significant doubt as to whether the debtor will continue to be a going concern.
- Currently, the debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- Based on estimates and projections that only encompass the current business capabilities, the debtor forecasts that its entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity.
- Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

55-9 Notwithstanding the above, the following factors, if both are present, provide determinative evidence that the debtor is not experiencing financial difficulties, and, thus, the modification or exchange is not within the scope of this Subtopic (the presence of either factor individually would be an indicator, but not determinative, that the debtor is not experiencing financial difficulty):

- The debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a nontroubled debtor.
- The creditors agree to restructure the old debt solely to reflect a decrease in current market interest rates for the debtor or positive changes in the creditworthiness of the debtor since the debt was originally issued.

A debt restructuring is not a TDR unless the debtor was experiencing financial difficulties when the modification or exchange took place. This criterion

recognizes that when a debtor experiences financial difficulty and is unable to meet its debt obligations, a creditor must evaluate its options.

For example, if a debtor is in default of the debt agreement, a creditor may be able to demand immediate payment and potentially force the debtor into bankruptcy. Alternatively, if the debt is secured by collateral, a creditor may be able to demand that the debtor transfer the collateral to the creditor.

However, a creditor may determine that restructuring the debt is the best way to minimize its loss. Restructuring the debt may allow the creditor to obtain more cash or other value by granting concessions to the debtor as compared to other available options.



Question 4.2.60

How are credit ratings considered in evaluating whether a debtor is experiencing financial difficulty?

Interpretive response: We believe the restructuring of a debt with an investment grade credit rating at the time of restructuring cannot be a TDR because such credit ratings are not indicative of financial difficulty; consequently, the restructuring is not a TDR.

In contrast, we believe debt with a non-investment grade credit rating at the time of restructuring must be analyzed to determine if it is a TDR.

Credit rating at debt issuance	Credit rating at time of restructuring:	
	Investment grade	Non-investment grade
Investment grade	Not a TDR	TDR analysis performed
Non-investment grade	Not a TDR	TDR analysis performed

The credit rating of a debt instrument at the time of restructuring is a determinative factor when evaluating whether it must be analyzed as a TDR, as indicated in the table. Positive changes in a debt instrument's credit rating from the time of issuance to restructuring is also a determinative factor that a restructuring is not a TDR (see Question 4.2.70).

For debt instruments that have current third-party credit ratings, this analysis may be relatively easy. However, if the debt instrument does not have current third-party credit ratings at the time of restructuring, it may be prudent to assume the TDR analysis must be performed as attempting to determine a third-party credit rating for debt may not be practical.



Question 4.2.70

What determinative factors, if present, provide conclusive evidence that the debtor is not experiencing financial difficulty?

Interpretive response: The presence of both of the following factors is conclusive evidence that a debtor is not experiencing financial difficulty and therefore the modification or exchange is not a TDR.

Determinative factors	
A debtor is not experiencing financial difficulty if both are present:	The debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a nontroubled debtor. [470-60-55-9(a)] We believe that a comparison to competitors or similar entities within the debtor's industry is an appropriate benchmark when evaluating the current market interest rate for a nontroubled debtor; this is regardless of whether such entities have comparable credit ratings.
	The creditors agree to restructure the old debt solely to reflect a decrease in current market interest rates for the debtor or positive changes in the creditworthiness of the debtor since the debt was originally issued. [470-60-55-9(b)]

Further, an investment grade credit rating at the time of restructuring is also a determinative factor that a debtor is not experiencing financial difficulties (see Question 4.2.60). [470-60-55-7]



Question 4.2.80

What factors should a debtor consider when evaluating if it is experiencing financial difficulty?

Interpretive response: If the determinative factors referenced in Questions 4.2.60 and 4.2.70 are not present, the following factors are indicators that a debtor is experiencing financial difficulty.

The debtor is currently in default on any of its debt. [470-60-55-8(a)]

The debtor has declared or is in the process of declaring bankruptcy. [470-60-55-8(b)]

There is significant doubt as to whether the debtor will continue to be a going concern. [470-60-55-8(c)]

Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (are available to be issued). See chapter 2 of KPMG Handbook, [Going concern](#). [205-40 Glossary]

Currently, the debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange. [470-60-55-8(d)]

Based on estimates and projections that only encompass the current business capabilities, the debtor forecasts that its entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity. [470-60-55-8(e)]

We believe this analysis should incorporate the current business capability of the debtor, which should assume normal operations. Normal operations of the debtor could include use of current credit facilities in place (e.g. revolving lines of credit) used for operating purposes, but do not include the sale or shut down of the business operations in order to service the debt. We believe cash flow forecasts in this analysis should contemplate the relationship to projections used in evaluating other accounting considerations, such as for tax or impairment analysis purposes.

Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor. [470-60-55-8(f)]

We believe that comparison to competitors or similar entities in the debtor's industry is an appropriate benchmark when evaluating the current market interest rate for a nontroubled debtor. This is regardless of whether such entities have comparable credit ratings.

4.2.60 Creditor has granted a concession criterion



Excerpt from ASC 470-60

- > Distinguishing Between a Troubled Debt Restructuring and a Modification or Exchange

55-6 The following factors have no relevance in the determination of whether a modification or an exchange is within the scope of this Subtopic:

- The amount invested in the old debt by the current creditors
- The **fair value** of the old debt immediately before the modification or exchange compared to the fair value of the new debt at issuance
- Transactions among debt holders.

In addition, the length of time the current creditors have held the investment in the old debt is not relevant in the determination of whether a modification or exchange is within the scope of this Subtopic unless all the current creditors recently acquired the debt from the previous debt holders to effect what is in substance a planned refinancing.

- • > Determining Whether the Creditor Granted a Concession

55-10 A creditor is deemed to have granted a concession if the debtor's effective borrowing rate on the restructured debt is less than the effective borrowing rate of the old debt immediately before the restructuring. The effective borrowing rate of the restructured debt (after giving effect to all the terms of the restructured debt including any new or revised options or

warrants, any new or revised guarantees or letters of credit, and so forth) should be calculated by projecting all the cash flows under the new terms and solving for the discount rate that equates the present value of the cash flows under the new terms to the debtor's current **carrying amount** of the old debt.

55-11 The carrying amount for purposes of this test would not include any hedging effects (including basis adjustments to the old debt) but would include any unamortized premium, discount, issuance costs, accrued interest payable, and so forth.

The second TDR criterion is that the creditor has granted the debtor a concession. [470-60-15-4]



Question 4.2.90

What constitutes a creditor concession?

Interpretive response: A creditor concession can take many forms, such as a reduction of the stated interest rate, an extension of the debt's maturity date at a stated interest rate that is lower than the current market rate, a reduction in the debt's par value or maturity amount, or a reduction in accrued interest.

For any of these or other circumstances to constitute a concession, the debtor's effective borrowing rate on the restructured debt has to be less than the effective borrowing rate on the original debt immediately before the restructuring.

The new effective borrowing rate is the discount rate that equates the present value of the projected cash flows under the restructured debt with the debtor's current carrying amount of the old debt. The old debt's carrying amount includes any unamortized/unaccreted premium, discount, issuance costs, accrued interest payable, etc. However, the carrying amount does not include any hedging effects. [470-60-15-9(c), 55-10 – 55-11]



Example 4.2.10

Determining whether the creditor has granted a concession

Debtor issues a \$1.5 million term loan on January 1, Year 4 for par.

- The loan has a five-year term and bears interest at 7%, payable annually on December 31.
- The principal amount of the loan is repayable in a single balloon payment on December 31, Year 9.
- The carrying amount of the loan at December 31, Year 4 is \$1.5 million.

Because the loan is issued at par (and ignoring the effect of issuance costs, if any), the effective borrowing rate of this loan is equal to the coupon rate of 7%.

Modification of debt

Debtor negotiates a restructuring of this loan on December 31, Year 4, whereby Creditor agrees to forgive \$100,000 of principal, extend the maturity date by one year, and decrease the coupon rate to 4%.

A summary of the terms of the restructured debt arrangement are as follows.

- The principal amount is reduced from \$1.5 million to \$1.4 million.
- The interest rate is reduced from 7 to 4%.
- The maturity date is extended by one year, to December 31, Year 10.
- The principal amount of the loan is repayable in a single balloon payment on maturity.

Determining if concession received

To determine whether it has received a concession from Creditor, Debtor compares the effective interest rate of the restructured debt to the effective interest rate of the original debt. The effective interest rate of the restructured debt is the rate necessary to equate the present value of the future cash flows of the modified debt to the carrying amount of the original debt at the date of modification. [470-60-55-10]

The following table illustrates the future cash flows of the modified debt.

	12/31/Y5	12/31/Y6	12/31/Y7	12/31/Y8	12/31/Y9	12/31/Y10	Total
Principal payment						\$1,400,000	\$1,400,000
Interest payments	\$56,000	\$56,000	\$56,000	\$56,000	\$56,000	\$ 56,000	\$ 336,000
Total payments	\$56,000	\$56,000	\$56,000	\$56,000	\$56,000	\$1,456,000	\$1,736,000

The effective borrowing rate is the discount rate that when applied to \$1,736,000 (future cash flows under the new terms) yields a present value of \$1.5 million (carrying amount of original debt). The effective interest rate calculated needs to be based on the same number of periods as the new terms of the restructured debt (i.e. six remaining years).

As a result, the effective borrowing rate is approximately 2.69%. When that rate is applied to \$1,736,000 over a six-year period, the discounted value approximates \$1.5 million. This equates the present value of the future cash flows of the new debt to the carrying amount of the existing debt.

Because the effective interest rate of 2.69% is lower than the effective interest rate of the original debt (7%), the lender has granted a concession.



Question 4.2.100

Can the creditor's effective rate on the debt immediately before the restructuring be compared to the effective rate on the restructured debt?

Interpretive response: No. The amount invested in the old debt by the current creditors, or the current carrying amount in their books, is not relevant for purposes of performing the concession test in Subtopic 470-60. [\[470-60-55-6\(a\)\]](#)

The concession test does not incorporate the creditors' basis in the debt because such information either is not readily assessable or is not verifiable by the debtor. Further, such information may unnecessarily incorporate irrelevant facts – e.g. one creditor may carry its investment at amortized cost while another may remeasure its investment to fair value.

However, using the creditor's effective rate may be allowed in the rare circumstance that all the current creditors (of the entire issuance of debt that is being restructured) recently acquired the debt (from the original creditors) in a planned refinancing that the debtor and the new creditors legally performed. In this case, the amount newly invested by the new creditors is readily verifiable and accessible by the debtor and may be more indicative of whether the new investors granted a concession. [\[470-60-55-6\]](#)



Question 4.2.110

How is the effective borrowing rate calculated if the debtor had restructured the debt shortly before the current restructuring?



Excerpt from ASC 470-60

• • > Determining Whether the Creditor Granted a Concession

55-14 Notwithstanding the guidance in this Section, if an entity has recently restructured the debt and is currently restructuring that debt again, the effective borrowing rate of the restructured debt (after giving effect to all the terms of the restructured debt including any new or revised options or warrants, any new or revised guarantees or letters of credit, and so forth) should be calculated by projecting all the cash flows under the new terms and solving for the discount rate that equates the present value of the cash flows under the new terms to the debtor's previous carrying amount of the debt immediately preceding the earlier restructuring. In addition, the effective borrowing rate of the restructured debt should be compared with the effective borrowing rate of the debt immediately preceding the earlier restructuring for purposes of determining whether the creditor granted a concession (that is, whether the effective borrowing rate decreased).

Interpretive response: If the debtor has recently (i.e. within the last year) restructured a debt instrument with a creditor before the current restructuring, it ignores the recent restructuring when determining whether the creditor granted a concession. Instead, it compares the: [\[470-60-55-14\]](#)

- new effective borrowing rate; and
- the effective borrowing rate of the debt immediately preceding the earlier restructuring.

For example, if a debtor restructured a debt on January 1, Year 2 and then restructures the debt again on April 1, Year 2, it calculates the effective interest rate for the newly restructured debt by determining the discount rate that equates the present value of the future cash flows of the debt under the new terms (as of April 1, Year 2) to the carrying amount of the debt as of December 31, Year 1. In evaluating whether the creditor granted a concession, the debtor compares the effective interest rate of the newly restructured debt and the effective interest rate of the debt as of December 31, Year 1 (immediately preceding the January 1, Year 2 restructuring).



Question 4.2.120

How do sweeteners affect whether a creditor has granted a concession?



Excerpt from ASC 470-60

- • > Determining Whether the Creditor Granted a Concession

55-12 When determining the effect of any new or revised sweeteners (options, warrants, guarantees, letters of credit, and so forth), the current fair value of the new sweetener or change in fair value of the revised sweetener would be included in day-one cash flows. If such sweeteners are not exercisable for a period of time, that delay is typically considered within the estimation of the initial fair value as of the debt's modification date.

Interpretive response: In a debt restructuring, the debtor may provide new sweeteners (e.g. equity shares, options, warrants, guarantees, letters of credit) to the creditor or it may enhance the terms of existing sweeteners. When projecting cash flows to determine the new effective borrowing rate, the fair value of a new sweetener or the change in fair value of a revised sweetener is treated as a modification-date cash flow of the modified debt. [\[470-60-55-12\]](#)

**Question 4.2.130****What if future cash flows are contingent or unknown?**

Interpretive response: In determining future cash payments, a debtor may need to estimate certain amounts. Generally, when estimating future cash flows that are contingent or unknown, the debtor includes all maximum potential cash flows in future cash payments. [470-60-35-7, 35-11]

The following are examples.

- **Creditor has right to demand payment at any time.** The amount of future interest payments may be unknown because the creditor has the right to demand payment at any time; therefore, the precise term and future coupon interest payments of the new debt are unknown. In this situation, the debtor should estimate total future cash payments based on the maximum number of periods possible under the restructured terms.
- **Debtor has right to prepay at any time.** The amount of future interest payments may be unknown because the debtor has the right to prepay at any time; therefore, the precise term and future coupon interest payments of the new debt are unknown. In this situation, the debtor estimates total future cash payments based on the maximum number of periods possible under the restructured terms.
- **Variable interest rate.** The amount of future interest payments may be unknown because the interest rate varies. If the restructured debt has a variable interest rate, the debtor uses the interest rate in effect at the time of the restructuring and projects future cash flows under an assumption that the rate will remain unchanged through the term of the restructured debt.

**Question 4.2.140****Are there circumstances in which a decrease in the effective borrowing rate does not represent a concession granted by the creditor?****Excerpt from ASC 470-60**

- • > Determining Whether the Creditor Granted a Concession

55-13 Although considered rare, if there is persuasive evidence that the decrease in the effective borrowing rate is due solely to a factor that is not captured in the mathematical calculation (for example, additional collateral), the creditor may not have granted a concession and the modification or exchange should be evaluated based on the substance of the modification.

Interpretive response: Yes, although rare, if there is persuasive evidence that a decrease in the effective borrowing rate in a debt restructuring is due solely to a factor that is not captured in the mathematical calculation of the present value of the cash flows (e.g. the provision of additional collateral), the creditor may not have granted a concession. Instead, the decrease in the borrowing rate may reflect a substantive increase in creditworthiness or other reduction in risk factors for the creditor. [470-60-55-13]

In this case, the debtor evaluates the debt restructuring based on the substance of the modification or exchange. For example, if a debtor provides a creditor with additional collateral, judgment is necessary to assess the effect of the additional collateral in the overall evaluation of the restructuring – i.e. in determining whether a concession occurred.

If the creditor has not granted a concession, the guidance in Subtopic 470-50 is applied to determine whether the modification or exchange is accounted for as a debt extinguishment (see section 4.4).

While it may be acceptable to evaluate the decrease in the borrowing rate as a reflection of additional collateral and not as a reflection of the creditor granting a concession for purposes of whether the restructuring is in the scope of a TDR, such judgment is not typically permitted when determining whether there is a significant modification of the debt instrument under Subtopic 470-50 (see Question 4.4.160).

4.3 Accounting for a TDR

4.3.10 Overview



Excerpt from ASC 470-60

35-1 A debtor shall account for a **troubled debt restructuring** according to the type of the restructuring as prescribed in this Section.

This section 4.3 provides guidance on accounting for a TDR, including when a gain is recognized for different types of restructurings. For modifications or exchanges of freestanding equity-classified written call options, see also section 8.13.40.



Question 4.3.10

Can a TDR result in the recognition of a gain?

Interpretive response: It depends. Once a debtor determines that a debt restructuring is a TDR, it may have a gain due to the creditor's concession. However, Subtopic 470-60 generally limits the occurrence or extent of gains resulting from a TDR. Whether a gain exists and how it is computed depends

on whether the debt restructuring involves a full or partial settlement (i.e. a transfer of assets or grant of equity interest to the creditor), or a modification of the debt. [470-60-35-6]

The following sections include further discussion on when a TDR may result in a gain on restructuring.

Full or partial settlement without modification	section 4.3.20
Modification with no asset transfer	section 4.3.30
Partial settlement of debt and modification of terms	section 4.3.50

4.3.20 Full or partial settlement without modification



Excerpt from ASC 470-60

35-2 A debtor that transfers its receivables from third parties, real estate, or other assets to a creditor to settle fully a payable shall recognize a gain on restructuring of payables. The gain shall be measured by the excess of the **carrying amount** of the payable over the **fair value** of the assets transferred to the creditor. However, while the guidance in this Subtopic indicates that the fair value of assets transferred or the fair value of an equity interest granted shall be used in accounting for a settlement of a payable in a troubled debt restructuring, that guidance is not intended to preclude using the fair value of the payable settled if more clearly evident than the fair value of the assets transferred or of the equity interest granted in a full settlement of a payable. However, in a partial settlement of a payable, the fair value of the assets transferred or of the equity interest granted shall be used in all cases to avoid the need to allocate the fair value of the payable between the part settled and the part still outstanding.

35-3 A difference between the fair value and the carrying amount of assets transferred to a creditor to settle a payable is a gain or loss on transfer of assets. The carrying amount of a receivable encompasses not only unamortized premium, discount, acquisition costs, and the like but also an allowance for uncollectible amounts and other valuation accounts, if any. The debtor shall include that gain or loss in measuring net income for the period of transfer, reported as provided in Topic 220. A loss on transferring receivables to creditors may therefore have been wholly or partially recognized in measuring net income before the transfer and be wholly or partly a reduction of a valuation account rather than a gain or loss in measuring net income for the period of the transfer.

35-4 A debtor that issues or otherwise grants an equity interest to a creditor to settle fully a payable shall account for the equity interest at its fair value. The difference between the fair value of the equity interest granted and the carrying amount of the payable settled shall be recognized as a gain on restructuring of payables.

35-12 Legal fees and other direct costs that a debtor incurs in granting an equity interest to a creditor in a troubled debt restructuring shall reduce the amount otherwise recorded for that equity interest according to paragraphs 470-60-35-4 and 470-60-35-8. All other direct costs that a debtor incurs to effect a troubled debt restructuring shall be deducted in measuring gain on restructuring of payables or shall be included in expense for the period if no gain on restructuring is recognized.

If a TDR results in a full or partial settlement of the debt and there is no modification of the debt, the debtor recognizes any gain or loss on the settlement. That gain or loss generally is measured by the excess of the debt's carrying amount over the fair value of the assets transferred (or equity interest granted) to the creditor. However, in a full settlement, the fair value of the settled debt may be used instead of the fair value of the transferred assets (or granted equity interest) if the debt's fair value is more clearly evident. In contrast, the settled debt's fair value cannot be used in a partial settlement. [470-60-35-2 – 35-3]

If a debtor settles the debt by granting an equity interest, it records the equity at fair value, less any legal fees and other direct costs it incurs in granting the equity interest. All other direct costs of a settlement are deducted in measuring any gain but are reported in earnings in the current period if there is no gain. [470-60-35-4, 35-12]



Example 4.3.10

TDR – full and partial settlements (no modification)

Scenario 1: Full settlement by transferring assets

Debtor has a \$15 million note payable to Creditor due December 31, Year 6. As of January 1, Year 3, Debtor is experiencing financial difficulties and Creditor agrees to settle the note by accepting real estate with a fair value of \$8 million.

On that date, the carrying amount of the note is \$10.5 million after Debtor previously paid down \$4.5 million of the principal, and the carrying amount of the real estate is \$6 million.

As of the date of settlement (January 1, Year 3) Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Notes payable	10,500,000	
Real estate		6,000,000
Gain on restructuring of payable ¹		2,500,000
Gain on transfer of assets ²		2,000,000
<i>To recognize gain on settlement.</i>		
Notes:		
1. Carrying amount of note (\$10.5 million) – Fair value of assets transferred (\$8 million).		

2. Fair value of assets transferred (\$8 million) – Carrying amount of assets transferred (\$6 million).

Scenario 2: Partial settlement by transferring assets

Assume the same facts as Scenario 1 except the restructuring is only a partial settlement (and no other terms are modified). The calculation of the gain or loss on the restructuring of the debt and the calculation of the gain or loss on the transfer of assets is determined in the same manner as in Scenario 1.

Scenario 3: Full settlement by transferring equity

Debtor settles its debt by issuing 4 million common shares with a par value of \$1 and a fair value of \$2 per share. Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Notes payable	10,500,000	
Common shares		4,000,000
Gain on restructuring of payable ¹		2,500,000
APIC ²		4,000,000
<i>To recognize gain on settlement.</i>		
Notes:		
1. Carrying amount of note (\$10.5 million) – Fair value of shares issued (\$8 million).		
2. Fair value of shares issued (\$8 million) – Par value of shares issued (\$4 million).		

4.3.30 Modification with no asset transfer



Excerpt from ASC 470-60

35-5 A debtor in a troubled debt restructuring involving only modification of terms of a payable—that is, not involving a transfer of assets or grant of an equity interest—shall account for the effects of the restructuring prospectively from the time of restructuring, and shall not change the carrying amount of the payable at the **time of the restructuring** unless the carrying amount exceeds the total future cash payments specified by the new terms. Total future cash payments includes related accrued interest, if any, at the time of the restructuring that continues to be payable under the new terms. That is, the effects of changes in the amounts or timing (or both) of future cash payments designated as either interest or face amount shall be reflected in future periods. Interest expense shall be computed in a way such that a constant effective interest rate is applied to the carrying amount of the payable at the beginning of each period between restructuring and maturity (in substance the interest method prescribed by paragraphs 835-30-35-2 and 835-30-35-4 through 35-5). The new effective interest rate shall be the discount rate that equates the present value of the future cash payments specified by the new

terms (excluding amounts contingently payable) with the carrying amount of the payable.

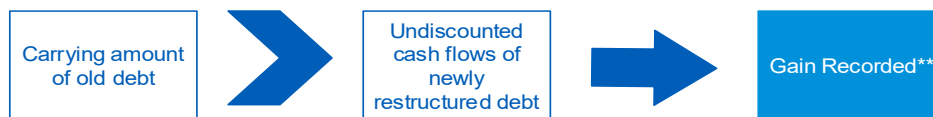
35-6 If, however, the total future cash payments specified by the new terms of a payable, including both payments designated as interest and those designated as face amount, are less than the carrying amount of the payable, the debtor shall reduce the carrying amount to an amount equal to the total future cash payments specified by the new terms and shall recognize a gain on restructuring of payables equal to the amount of the reduction. If the carrying amount of the payable comprises several accounts (for example, face amount, accrued interest, and unamortized premium, discount, finance charges, and issue costs) that are to be continued after the restructuring, some possibly being combined, the reduction in carrying amount may need to be allocated among the remaining accounts in proportion to the previous balances. Thereafter, all cash payments under the terms of the payable shall be accounted for as reductions of the carrying amount of the payable, and no interest expense shall be recognized on the payable for any period between the restructuring and maturity of the payable. The only exception is to recognize interest expense according to paragraph 470-60-35-10. However, the debtor may choose to carry the amount designated as face amount by the new terms in a separate account and adjust another account accordingly.



Question 4.3.20

How does a debtor determine if there is a gain on restructuring when there is no transfer of assets?

Interpretive response: When a TDR involves only a modification of the existing debt without a transfer of assets or issuance of equity to the creditor, a gain exists if the carrying amount of the old debt exceeds the undiscounted cash flows associated with the new debt, including direct fees paid to the lender to effect the TDR. [470-60-35-6]



** Additional consideration is given if future cash flows include contingent payments (see section 4.3.40).

In contrast, when the amount of undiscounted future cash flows (i.e. principal and interest payments) associated with the new or modified debt equals or exceeds the carrying amount of the old debt, the debtor will repay the entire carrying amount of the old debt over the term of the new or modified debt. As a result, no gain is recorded in the period in which the TDR occurs. This is true even if the present value of the cash flows, discounted at a current market rate associated with the new debt is less than the carrying amount of the old debt at the time of the restructuring.

4. TDRs, debt modifications and extinguishments



*** Additional consideration is given if future cash flows include contingent payments (see section 4.3.40).

The debtor accounts for these two situations as follows.

	Carrying amount of old debt > undiscounted cash flows of new debt	Carrying amount of old debt < undiscounted cash flows of new debt
Initial carrying amount of newly restructured debt	Recorded as amount of undiscounted future cash flows associated with the restructured debt. [470-60-35-6]	Same as carrying amount of original debt. [470-60-35-5]
Direct costs of restructuring (fees paid to lender and third parties)	Reduce the gain to the extent recorded. Any excess fees paid are expensed as incurred. [470-60-35-12]	We believe fees paid to the lender should be capitalized and amortized. Fees paid to third parties are expensed as incurred. [470-60-35-12]
Coupon interest payments subsequently made on the new debt	Reduce debt balance; not recorded as interest expense. [470-60-35-6]	The new effective interest rate is subsequently used to determine interest expense. The debtor calculates the new effective interest rate, which represents the discount rate that equates the present value of the revised future cash payments with the carrying amount of the debt. [470-60-35-5] The new effective interest rate may be lower than the coupon payments on the restructured debt. Therefore, the debtor will record interest expense at the new effective interest rate, realizing the benefit of the restructuring through decreases in the debt balance over the term of the modified debt for the difference between the coupon rate and the effective interest rate.



Example 4.3.20

Modification that is a TDR – gain recorded

Debtor has a debt of \$2 million.

- The debt bears interest at 8%, payable quarterly.
- The principal amount is repayable on December 31, Year 6.
- The carrying amount of the loan at December 31, Year 5 is \$2 million.

On December 31, Year 5, Debtor exchanges this debt for new debt that meets the criteria to be accounted for as a TDR.

- The principal amount is \$1.5 million.
- The debt bears interest at 9%, payable quarterly.
- The principal amount is repayable on December 31, Year 7.

Determining whether to record a gain

To determine if it needs to record a gain on the debt modification, Debtor first identifies the undiscounted future cash flows of the new debt arrangement.

	3/31/Y6	6/30/Y6	9/30/Y6	12/31/Y6	3/31/Y7	6/30/Y7	9/30/Y7	12/31/Y7	Total
Principal payment								\$1,500,000	\$1,500,000
Interest payments	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750	\$270,000
Total payments	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750	\$33,750	\$1,533,750	\$1,770,000

Debtor determines that the undiscounted future cash flows under the terms of the new debt are \$1.77 million. This amount is less than the carrying amount of the existing debt of \$2 million. Therefore, Debtor records a gain of \$230,000 on December 31, Year 5: Carrying amount of old debt (\$2 million) – Undiscounted future cash flows related to new debt (\$1.77 million).

Prospectively, Debtor will not recognize interest expense on the new debt. All of the future cash flows will be accounted for as a reduction of the carrying amount of the debt. Therefore, as coupon interest payments are made, they will decrease the debt carrying amount. The new carrying amount of the debt at the date of the restructuring of \$1.77 million (the undiscounted cash flows of the new debt) will be reduced each quarter by \$33,750 when cash is paid (cash interest payment based on the new principal amount of \$1.5 million and new annual coupon interest rate of 9%).

Example 4.3.70 discusses how Debtor presents this TDR modification in the financial statements.

**Example 4.3.30****Modification that is a TDR – no gain recorded**

Debtor has an unsecured \$1 million note payable to Creditor.

- The note bears interest at 10%, payable annually on December 31.
- The principal amount is repayable on December 31, Year 4.
- The carrying amount of the loan at December 31, Year 4 is \$1 million.

Debtor negotiates the following with Creditor on December 31, Year 4.

- The principal amount is reduced to \$900,000.
- The interest rate is reduced to 8%, payable annually on December 31.
- The maturity date is extended to December 31, Year 6.

The transaction meets the criteria to be accounted for as a TDR.

Determining whether to record a gain

To determine if it needs to record a gain on the debt modification, Debtor first calculates the total future cash flows from the restructured debt.

Interest payments ($\$900,000 \times 8\% \times 2$ years)	\$ 144,000
Repayment of principal	900,000
Total future cash flows (undiscounted)	\$1,044,000

Because the \$1.044 million total future cash flows exceed the carrying amount of the \$1 million debt, Debtor does not recognize a gain from the debt restructuring. In this example:

- the carrying amount of the original debt (\$1 million) becomes the carrying amount of the new debt; and
- Debtor computes a new effective interest rate that discounts the future cash payments to the carrying amount of the original debt. This results in an effective interest rate of 2.25% (rounded) based on the future cash flows and the carrying amount of the debt.

An effective interest rate of 2.25% is the constant interest rate that results in a carrying amount of the debt being \$900,000 on December 31, Year 6, the date the adjusted principal balance of \$900,000 is due to be repaid.

Debtor records the following journal entry on December 31, Year 5.

	<i>Debit</i>	<i>Credit</i>
Notes payable ¹	49,500	
Interest expense ²	22,500	
Cash ³		72,000
<i>To recognize annual interest payment.</i>		
Notes:		
1. Excess of cash payment over interest expense reduces carrying amount of the debt.		

2. \$1 million \times 2.25%.
3. \$900,000 \times 8% stated rate.

The carrying amount of the debt as of December 31, Year 5 is \$950,500 (\$1 million – \$49,500).

Debtor records the following journal entry on December 31, Year 6.

	<i>Debit</i>	<i>Credit</i>
Notes payable ¹	50,500	
Interest expense ²	21,500	
Cash ³		72,000
Notes payable	900,000	
Cash		900,000
<i>To recognize annual interest and principal payment.</i>		
Notes:		
1. Excess of cash payment over interest expense reduces carrying amount of the debt.		
2. (\$1 million – \$49,500) \times 2.25% (rounded).		
3. \$900,000 \times 8% stated rate.		

The following table summarizes the amortization of the premium and carrying amount each period.

Date	Interest payment	Interest expense	Premium amortization	Carrying amount
12/31/Y4	\$ –	\$ –	\$ –	\$1,000,000
12/31/Y5	72,000	22,500	49,500	950,500
12/31/Y6	72,000	21,500	50,500	900,000

4.3.40 Contingent payments and estimated future cash flows



Excerpt from ASC 470-60

35-7 A debtor shall not recognize a gain on a restructured payable involving indeterminate future cash payments as long as the maximum total future cash payments may exceed the carrying amount of the payable. Amounts designated either as interest or as face amount by the new terms may be payable contingent on a specified event or circumstance (for example, the debtor may be required to pay specified amounts if its financial condition improves to a specified degree within a specified period). To determine

whether the debtor shall recognize a gain according to the provisions of the preceding two paragraphs, those contingent amounts shall be included in the total future cash payments specified by the new terms to the extent necessary to prevent recognizing a gain at the time of restructuring that may be offset by future interest expense. Thus, the debtor shall apply paragraphs 450-30-25-1 and 450-30-50-1 in which probability of occurrence of a gain contingency is not a factor, and shall assume that contingent future payments will have to be paid. The same principle applies to amounts of future cash payments that must sometimes be estimated to apply the provisions of the preceding two paragraphs. For example, if the number of future interest payments is flexible because the face amount and accrued interest is payable on demand or becomes payable on demand, estimates of total future cash payments shall be based on the maximum number of periods possible under the restructured terms.

35-10 If a troubled debt restructuring involves amounts contingently payable, those contingent amounts shall be recognized as a payable and as interest expense in future periods in accordance with paragraph 450-20-25-2. Thus, in general, interest expense for contingent payments shall be recognized in each period in which both of the following conditions exist:

- a. It is probable that a liability has been incurred.
- b. The amount of that liability can be reasonably estimated.

Before recognizing a payable and interest expense for amounts contingently payable, however, accrual or payment of those amounts shall be deducted from the carrying amount of the restructured payable to the extent that contingent payments included in total future cash payments specified by the new terms prevented recognition of a gain at the time of restructuring (see paragraph 470-60-35-7).

35-11 If amounts of future cash payments must be estimated to apply the provisions of paragraphs 470-60-35-5 through 35-7 because future interest payments are expected to fluctuate—for example, the restructured terms may specify the stated interest rate to be the prime interest rate increased by a specified amount or proportion—estimates of maximum total future payments shall be based on the interest rate in effect at the time of the restructuring. Fluctuations in the effective interest rate after the restructuring from changes in the prime rate or other causes shall be accounted for as changes in estimates in the periods in which the changes occur. However, the accounting for those fluctuations shall not result in recognizing a gain on restructuring that may be offset by future cash payments (see the preceding paragraph and paragraph 470-60-35-7). Rather, the carrying amount of the restructured payable shall remain unchanged, and future cash payments shall reduce the carrying amount until the time that any gain recognized cannot be offset by future cash payments.

A TDR may involve amounts that are contingently payable. For example, the debtor may be required to pay specific amounts if its financial condition improves by certain parameters within a particular time period. When determining the total future cash payments of the modified debt, the debtor assumes it will make the future contingent payments – i.e. the calculation of the total future cash payments is not subject to the probability that the

contingent payments will be made. This is because the TDR model is designed to delay and reduce any gain recognition from the restructuring. Therefore, a debtor does not recognize a gain on a TDR if it may be required to make a contingent payment(s) and the amount of the contingent payment causes the total future undiscounted cash flows to exceed the carrying amount of the debt. [470-60-35-7]

Subtopic 450-20 prohibits a debtor from recognizing a liability for the contingent amounts until the probability threshold has been met and the amount of the liability can be reasonably estimated. [470-60-35-10]

Similarly, a debtor does not recognize a gain on a restructured debt instrument that involves indeterminate future cash payments if the maximum total future cash payments may exceed the carrying amount of the original debt. In this case, the restructured debt keeps the same carrying amount as the original debt. Future cash payments reduce the restructured debt's carrying amount until the time that any gain cannot be offset by potential future cash payments. [470-60-35-11]



Example 4.3.40

TDR involving contingent payments

On January 1, Year 1, Debtor issues a five-year, \$5 million note to Creditor.

- The interest rate is 10%, payable annually on December 31.
- The maturity date is December 31, Year 5.

Three years later, Debtor is experiencing financial difficulties, and on January 1, Year 4, Debtor and Creditor restructure the debt as follows.

- The principal amount is reduced to \$3.5 million.
- The interest rate is reduced to 7%.
- The maturity date is extended by three years, to January 1, Year 9.
- Debtor agrees to pay an additional \$750,000 to Creditor on maturity of the debt if Debtor achieves certain profit thresholds throughout the remaining term of the debt.

Debtor accounts for the transaction as a TDR because it is experiencing financial difficulties and Creditor has agreed to concessions it would not otherwise consider, including reducing the principal balance and the interest rate such that the effective borrowing rate on the restructured debt is less than the effective borrowing rate on the original debt immediately before the restructuring.

Accounting for the TDR

To determine if it should recognize a gain as a result of the restructuring, Debtor compares the undiscounted future cash flows of the modified debt arrangement to the carrying amount of the debt before restructuring.

The carrying amount of the debt before the restructuring is \$5 million. The undiscounted future cash flows of the new debt are computed as follows.

4. TDRs, debt modifications and extinguishments

Interest payments (\$3.5 million × 7% × 5 years)	\$1,225,000
Repayment of principal	3,500,000
Contingent payment	750,000
Total future cash flows	<u>\$5,475,000</u>

Debtor does not recognize a gain on the debt restructuring because the future undiscounted cash payments, including the contingent amount, exceed the carrying amount of the debt at the time of the restructuring.

Debtor does not record the contingent payment until it is probable that it has incurred a liability and the amount of the liability can be reasonably estimated. At the date of the debt restructuring, Debtor determines that it is not probable that it will be required to make the contingent payment. Therefore, Debtor continues to carry the note on its balance sheet at \$5 million as of the date of the restructuring.

Debtor computes a new effective interest rate based on the carrying amount of the debt and the future cash flows. The cash flows used to compute this new rate exclude the contingent amount because its payment is not probable. Debtor determines that the effective interest rate for the modified debt is zero because the future cash flows, excluding the contingent amount, are only \$4.725 million, which is less than the \$5 million carrying amount of the debt before the restructuring.

While contingency remains not probable of occurring

Each reporting period, Debtor assesses the probability of making the contingent payment and any effect on the effective interest rate. In Years 4 to 7, Debtor determines it is not probable that it will be required to make the contingent payment. Therefore, the effective interest rate continues to be zero in those years. When the effective interest rate is zero, no interest expense is recorded.

Instead, Debtor records the coupon interest payment (\$3.5 million × 7%) as a reduction of the note in the following journal entry. This effectively amortizes the difference between the carrying amount of the debt and the amount due at maturity.

	<i>Debit</i>	<i>Credit</i>
Notes payable	245,000	
Cash		245,000
<i>To recognize interest payments.</i>		

The balance of the note payable on December 31, Year 7 is \$4.02 million: \$5 million – (\$245,000 × 4 years).

When contingency becomes probable of occurring

In Year 8, Debtor determines it is probable that it will achieve the profit target and will be required to pay the additional \$750,000.

Debtor is not required to immediately record the contingent payment as expense. Instead, it compares the total amount to be paid at maturity to the

4. TDRs, debt modifications and extinguishments

carrying amount of the debt as of January 1, Year 8. It recognizes additional interest expense over the remaining term of the debt by accreting the carrying amount of the note to the amount to be paid at maturity.

Debtor determines the amount of additional interest expense as follows.

Payment at maturity (\$3.5 million + \$750,000)	\$ 4,250,000
Carrying amount at January 1, Year 8	(4,020,000)
Additional interest to be accrued to maturity	<u>\$ 230,000</u>

Debtor determines a new effective interest rate considering the revised future cash flows (summarized below), which now exceed the carrying amount of the note of \$4.02 million at January 1, Year 8.

Principal amount	\$ 3,500,000
Interest payments (\$3.5 million × 7% × 1 year)	245,000
Contingent payment	750,000
Total future cash payments	<u>\$ 4,495,000</u>

The new effective interest rate is the discount rate that makes the present value of the remaining future cash flows of the debt (\$4.495 million) equal to the carrying amount of the debt at the date the contingent payment became probable (\$4.02 million at January 1, Year 8).

The new effective interest rate is 11.8% (rounded), and interest expense for Year 8 is \$475,000 (\$4.02 million × 11.8%). Viewed another way, interest expense for Year 8 comprises the stated interest of \$245,000 plus the additional interest of \$230,000 resulting from the accretion of the carrying amount of the note to the amount to be paid at maturity.

Debtor records the following journal entry in Year 8.

	<i>Debit</i>	<i>Credit</i>
Interest expense ¹	475,000	
Notes payable ²		230,000
Cash ³		245,000
<i>To recognize annual interest payment.</i>		
Notes:		
1. \$4.02 million × 11.8% (rounded).		
2. Revised amount paid at maturity (\$4.25 million) – Carrying amount of debt when contingent payment became probable (\$4.02 million at January 1, Year 8).		
3. \$3.5 million × 7%.		

The balance of the note payable on December 31, Year 8 is \$4.25 million, which is the amount Debtor must pay on January 1, Year 9.

Debtor records the following journal entry in Year 9.

	<i>Debit</i>	<i>Credit</i>
Notes payable ¹	4,250,000	
Cash ¹		4,250,000
<i>To recognize repayment of debt on January 1, Year 9.</i>		
Note:		
1. Represents the amount due at maturity on January 1, Year 9.		

If the contingent payment, previously determined as being probable of occurring, is not due upon maturity, Debtor recognizes a gain on extinguishment for the difference between the final payment and carrying amount of the debt.

4.3.50 Partial settlement of debt and modification of terms



Excerpt from ASC 470-60

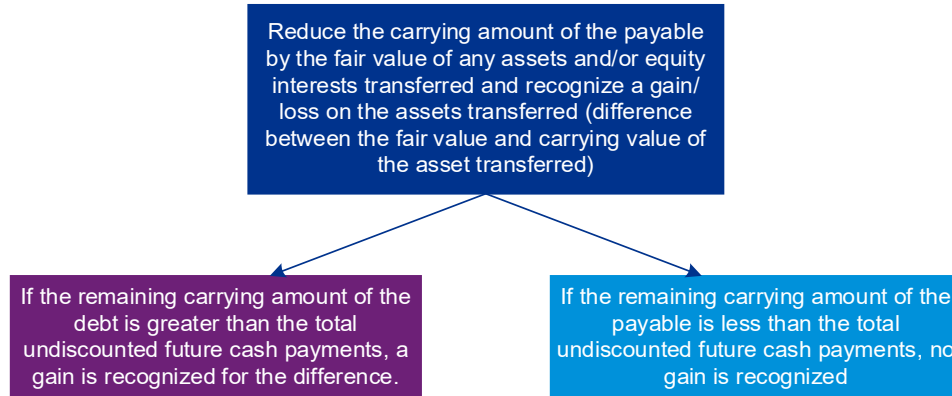
35-8 A troubled debt restructuring may involve partial settlement of a payable by the debtor's transferring assets or granting an equity interest (or both) to the creditor and modification of terms of the remaining payable. Even if the stated terms of the remaining payable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the transfer of assets or grant of an equity interest, the restructuring shall be accounted for as prescribed by this guidance. A debtor shall account for a troubled debt restructuring involving a partial settlement and a modification of terms as prescribed in paragraphs 470-60-35-5 through 35-7 except that, first, assets transferred or an equity interest granted in that partial settlement shall be measured as prescribed in paragraphs 470-60-35-2 and 470-60-35-4, respectively, and the carrying amount of the payable shall be reduced by the total fair value of those assets or equity interest. If cash is paid in a partial settlement of a payable in a troubled debt restructuring, the carrying amount of the payable shall be reduced by the amount of cash paid. A difference between the fair value and the carrying amount of assets transferred to the creditor shall be recognized as a gain or loss on transfer of assets. No gain on restructuring of payables shall be recognized unless the remaining carrying amount of the payable exceeds the total future cash payments (including amounts contingently payable) specified by the terms of the debt remaining unsettled after the restructuring. Future interest expense, if any, shall be determined according to the provisions of paragraphs 470-60-35-5 through 35-7.

35-9 A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor or other transfer of assets to the creditor shall be accounted for according to the provisions of the preceding paragraph and paragraphs 470-60-35-2 through 35-3.

A TDR can involve:

- a partial settlement of a payable by transferring assets and/or equity interests; and
- a modification of terms of the remaining payable.

In such cases, the TDR is accounted for as follows.



Example 4.3.50

TDR – partial settlement (with modification)

Debtor has a \$15 million note payable to Creditor.

- The note bears interest at 5%, payable annually on December 31.
- The principal amount is repayable on December 31, Year 6.
- The carrying amount of the note at January 1, Year 4 is \$10.5 million.

Because Debtor is experiencing financial difficulties, on January 1, Year 4 Creditor agrees to partially settle the note by accepting real estate and modifying the terms of the note.

- The real estate has a carrying amount of \$6 million and a fair value of \$8 million.
- The principal amount is reduced to \$2 million – i.e. by the fair value of the real estate and an additional \$500,000.
- The interest rate is increased to 7%.
- The maturity date remains the same, December 31, Year 6.

Determining the gain or loss

To determine if a gain or loss is recognized on the restructuring of the note, Debtor first determines the undiscounted cash flows of the restructured debt.

Interest payments ($\$2 \text{ million} \times 7\% \times 3 \text{ years}$)	\$ 420,000
Repayment of principal	2,000,000
Total future cash flows (undiscounted)	\$ 2,420,000

Because the total future undiscounted cash flows are less than the original carrying amount of the remaining debt of \$2.5 million, a gain of \$80,000 is recognized on the restructuring.

Further, a \$2 million gain is recognized on the transfer of the real estate for the difference between its fair value (\$8 million) and carrying amount (\$6 million).

Further, because the total future undiscounted cash flows are less than the carrying amount of the remaining debt before modification (\$2.5 million), the effective interest rate on the new debt is zero. Therefore, Debtor will not recognize interest expense on the new debt prospectively.

All of the future cash flows will reduce the carrying amount of the debt. Therefore, as coupon interest payments are made, they will decrease the debt carrying amount. This means the new carrying amount of the debt at the date of the restructuring (\$2.42 million) will be reduced each year by \$140,000 when cash is paid (\$2 million \times 7%), such that at December 31, Year 6, the carrying amount of the debt will be the amount due on maturity (\$2 million).

As of the date of the partial settlement of the debt (January 1, Year 4), Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Notes payable ¹	8,080,000	
Real estate ²		6,000,000
Gain on transfer of assets ³		2,000,000
Gain on restructuring ⁴		80,000
<i>To recognize gain on restructuring and gain on transfer of asset and partial debt settlement.</i>		
Notes:		
1. To reduce carrying amount of debt to \$2.42 million (new undiscounted future cash flows of the debt).		
2. To record the transfer of real estate to the creditor used to settle the note payable.		
3. Fair value of real estate transferred (\$8 million) – Carrying amount of real estate transferred (\$6 million).		
4. Carrying amount of debt before modification (\$2.5 million) – Undiscounted future cash flows of modified debt (\$2.42 million).		

4.3.60 Evaluating multiple loans

As discussed in section 4.2.30, even if debt instruments or similar contracts are renegotiated with multiple creditors together, a group of instruments with one creditor is analyzed separately from loans with other creditors. However, all payables with the same creditor are generally included in one unit of account and therefore are analyzed together. Nevertheless, a debtor determines the first criterion for a TDR (i.e. the debtor is experiencing financial difficulties) on an entity-wide basis (see section 4.2.50). [470-60-15-4]



Question 4.3.30

How does the debtor account for a TDR when there are multiple loans with one creditor?

Interpretive response: When evaluating whether a debt restructuring is a TDR, we believe a debtor should consider its total relationship with each creditor. For example, the debtor may have more than one loan with the same creditor either before or after the restructuring. In such cases, the debtor should compare the combined future cash flows from the new debt instruments to the carrying amount of the original debt instruments (see Example 4.3.60).

If the debtor concludes that the restructuring is a TDR that results in no immediate gain recognition, it allocates the carrying amount of the original debt instruments to the new debt instruments in a manner that results in a constant effective interest rate on the new debt instruments from the date of modification to the date of settlement. [\[470-60-35-5\]](#)



Question 4.3.40

When there are multiple creditors involved, can the accounting conclusions differ from one creditor to another?

Interpretive response: Yes. In our experience, when a debt restructuring involves multiple creditors, it is possible that the evaluation of whether a creditor granted a concession may result in different conclusions for each of the creditors involved.

For example, a debtor may determine that a concession was granted by one creditor, and not granted by other creditors. This would result in the application of TDR accounting for one or more creditors, but further analysis under Subtopic 470-50 would be required for the other creditors (to evaluate whether each restructuring is a modification or extinguishment).



Example 4.3.60

Debt restructured into two debt instruments

Debtor has a \$10 million note payable.

- The note bears interest at 8%, payable annually on December 31.
- The principal amount is repayable on December 31, Year 4.
- Accrued interest on the note as of December 31, Year 4 is \$1 million.

On December 31, Year 4, Creditor modifies the terms of the note as part of a TDR, and the existing note is replaced with two new loans with the following terms.

4. TDRs, debt modifications and extinguishments

- Loan 1:
 - The principal amount is \$7 million.
 - The note bears interest at 10%, payable annually on December 31.
 - The term is two years, and the principal amount is repayable on December 31, Year 6.
- Loan 2:
 - The principal amount is \$2 million.
 - The note bears interest at 12%, payable annually on December 31.
 - The term is five years, and the principal amount is repayable on December 31, Year 9.

Determining whether there is a gain

To determine if a gain or loss is recognized on the restructuring of the note, Debtor first determines the undiscounted cash flows of the restructured debt.

Loan 1:	
Interest payments (\$7 million × 10% × 2 years)	\$ 1,400,000
Repayment of principal	7,000,000
Loan 2:	
Interest payments (\$2 million × 12% × 5 years)	1,200,000
Repayment of principal	2,000,000
Total future cash flows (undiscounted)	\$ 11,600,000

Debtor does not recognize a gain on the debt restructuring because the future undiscounted cash flows of the modified debt exceed the carrying amount of the existing debt of \$11 million: \$10 million principal + \$1 million accrued interest.

Therefore, Debtor allocates the total carrying amount of the old debt (including the accrued interest) to the two new debt instruments in a manner that results in a constant effective interest rate for both instruments after modification. The effective interest rate that results in a constant yield for the new cash flows (as compared to the \$11 million carrying amount) is 2.11%.

Year	Interest payments ¹	Principal payments	Interest expense ²	Amort. of premium ³	Carrying amount
Yr 5 opening					\$11,000,000
Yr 5	\$ 940,000		\$232,100	\$ 707,900	10,292,100
Yr 6	940,000	\$7,000,000	217,160	722,840	2,569,260
Yr 7	240,000		54,200	185,800	2,383,460
Yr 8	240,000		50,290	189,710	2,193,750
Yr 9	240,000	2,000,000	46,250	193,750	-
Total	\$2,600,000	\$9,000,000	\$600,000	\$2,000,000	

Notes:

1. The interest in Years 5 and 6 comprises loan 1 (\$700,000) and loan 2 (\$240,000).
2. Calculated using the effective interest rate of 2.11%. The total interest expense equals the difference between the total cash payments on the new loans (\$11.6 million) and the carrying amount of the original note of \$11 million.
3. The difference between the carrying amount of the original note (\$11 million) and the combined principal amounts of the two new loans (\$9 million).

To yield 2.11% versus the \$11 million carrying amount of the debt at the date of modification, approximately \$8.1 million is allocated to Loan 1 (the two-year note) and approximately \$2.9 million is allocated to Loan 2 (the five-year note). This is illustrated in the tables that follow (numbers are rounded).

Loan 1 (two-year loan)

Year	Interest payments	Principal payments	Interest expense ¹	Amort. of premium ²	Carrying amount
Yr 5 opening					\$8,070,625
Yr 5	\$ 700,000		\$170,275	\$ 529,725	7,540,900
Yr 6	700,000	\$7,000,000	159,100	540,900	-
Total	\$1,400,000	\$7,000,000	\$329,375	\$1,070,625	

Notes:

1. Calculated using the effective interest rate of 2.11%. The total interest expense equals the difference between the total cash payments on the new loans (\$8.4 million) and the initial allocated carrying amount (\$8,070,625).
2. The difference between the allocated carrying amount (\$8,070,625) and the principal amount of the new loan (\$7 million).

Loan 2 (five-year loan)

Year	Interest payments	Principal payments	Interest expense ¹	Amort. of premium ²	Carrying amount
Yr 5 opening					\$2,929,375
Yr 5	\$ 240,000		\$61,805	\$ 178,195	2,751,180
Yr 6	240,000		58,050	181,950	2,569,230
Yr 7	240,000		54,200	185,800	2,383,430
Yr 8	240,000		50,290	189,710	2,193,720
Yr 9	240,000	2,000,000	46,280	193,720	-
Total	\$1,200,000	\$2,000,000	\$270,625	\$929,375	

Notes:

1. Calculated using the effective interest rate of 2.11%. The total interest expense equals the difference between the total cash payments on the new loans (\$3.2 million) and the initial allocated carrying amount (\$2,929,375).
2. The difference between the allocated carrying amount (\$2,929,375) and the principal amount of the new loan (\$9 million).

Debtor records the following journal entry on December 31, Year 4.

	<i>Debit</i>	<i>Credit</i>
Accrued interest payable (Note) ¹	1,000,000	
Note payable ¹	10,000,000	
Loans payable (Loan 1) ²		8,070,625
Loans payable (Loan 2) ²		2,929,375
<i>To recognize debt modification.</i>		
Notes:		
1. To remove accrued interest forgiven and principal balance of original note.		
2. To record allocation of the carrying amount of the original note to the two new loans (as calculated above).		



Question 4.3.50

How does the debtor consider other existing loans with a creditor when not all loans are included in the restructuring?

Interpretive response: If a debtor holds multiple loans with a creditor, and only one (or some) of the loans is being restructured, all loans with the creditor are considered when evaluating whether a concession was granted. This means all loans outstanding with a creditor are considered when comparing the effective interest rate of the existing debt to the effective interest rate of the restructured debt.

Further, if the debtor is experiencing financial difficulties and a creditor is deemed to have granted a concession, the debtor views all loans with such creditor as one for TDR accounting purposes, including the determination of a gain on restructuring.

4.3.70 Presentation and disclosure of a TDR



Excerpt from ASC 470-60

45-1 All or a portion of the **carrying amount** of the payable at the **time of the restructuring** may need to be reclassified in the balance sheet because of changes in the terms, for example, a change in the amount of the payable due within one year after the date of the debtor's balance sheet.

45-2 A **troubled debt restructuring** of a short-term obligation after the date of a debtor's balance sheet but before that balance sheet is issued or is available to be issued (as discussed in Section 855-10-25) may affect the classification of that obligation in accordance with Subtopic 470-10.

50-1 A debtor shall disclose, either in the body of the financial statements or in the accompanying notes, all of the following information about **troubled debt restructurings** that have occurred during a period for which financial statements are presented:

- a. For each restructuring, a description of the principal changes in terms, the major features of settlement, or both; separate restructurings within a fiscal period for the same category of payables (for example, accounts payable or subordinated debentures) may be grouped for disclosure purposes
- b. Aggregate gain on restructuring of payables
- c. Aggregate net gain or loss on transfers of assets recognized during the period (see paragraphs 470-60-35-3 and 470-60-35-8)
- d. Per-share amount of the aggregate gain on restructuring of payables.

50-2 A debtor shall disclose in financial statements for periods after a troubled debt restructuring the extent to which amounts contingently payable are included in the **carrying amount** of restructured payables pursuant to the provisions of paragraph 470-60-35-7. If required by paragraphs 450-20-50-1 through 50-6 and 450-20-50-9 through 50-10, a debtor shall also disclose in those financial statements total amounts that are contingently payable on restructured payables and the conditions under which those amounts would become payable or would be forgiven.



Question 4.3.60

What are the financial statement presentation considerations for a TDR that results in a gain recognition at the date of modification?

Interpretive response:

Balance sheet

The amount recorded on the balance sheet for the new debt is the new debt's undiscounted future cash flows. Additionally, the classification of the new debt as current or noncurrent may be different as a result of the restructuring; section 3.6 addresses classification of debt.

Income statement

We believe the presentation of a TDR gain in the income statement is similar to the presentation of a debt extinguishment gain. Therefore, the gain is reported in earnings in the period the restructuring occurs, presented as a separate item in the income statement or disclosed in the notes.

Statement of cash flows

Under the indirect method of presenting the statement of cash flows, the gain is presented as a reconciling item to net income in the operating activities section similar to a debt extinguishment gain. See section 12.3 of KPMG Handbook, [Statement of cash flows](#).

**Example 4.3.70****Modification that is a TDR – gain recorded**

The amounts determined in Example 4.3.20 are presented as follows.

Gain on debt restructuring	The \$230,000 gain is presented in the income statement in the current period as a separate item (or disclosed). Similarly, under the indirect method of presenting the statement of cash flows, the gain is presented as a reconciling item to net income in the operating activities section similar to a debt extinguishment gain.
Carrying amount of the new debt	Although the legal amount of the new debt is \$1.5 million, the accounting carrying amount of the new debt of \$1.77 million is presented on the balance sheet.
Cash interest payments in the income statement and statement of cash flows	Debtor will pay actual interest charges each year of \$135,000 (\$1.5 million × 9%). It will not recognize interest expense on the debt in the income statement. Instead, it will reduce the debt balance by the amount of these interest payments. Because the \$135,000 of interest will reduce the principal balance, Debtor will reflect the payment as a cash outflow for repayment of debt in the financing activities section of the statement of cash flows. As a result, Debtor will not reflect the \$135,000 of interest as interest paid in the supplemental disclosures for the statement of cash flows.
Tax accounting considerations	When a TDR involves the exchange of debt instruments, if the accounting carrying amount of the original debt does not equal its tax basis under the new debt agreement, accounting for this difference may be required. Therefore, a debtor should determine the tax basis of the new debt, compare it to the new book basis of that debt, and record deferred taxes as appropriate. See chapter 2 of KPMG Handbook, Accounting for income taxes .

4.4 Identifying whether non-TDR debt restructurings are accounted for as extinguishments

4.4.10 Overview

**Excerpt from ASC 470-50**

> Modifications and Exchanges

40-6 An exchange of debt instruments with substantially different terms is a debt extinguishment and shall be accounted for in accordance with paragraph

405-20-40-1. A debtor could achieve the same economic effect as an exchange of a debt instrument by making a substantial modification of terms of an existing debt instrument. Accordingly, a substantial modification of terms shall be accounted for like an extinguishment.

If a debt restructuring is not a TDR (see section 4.2), the debtor applies Subtopic 470-50 to determine whether the restructuring is an extinguishment of the original debt (and issuance of new debt) or a modification of the original debt. [470-50-15-3(b)]

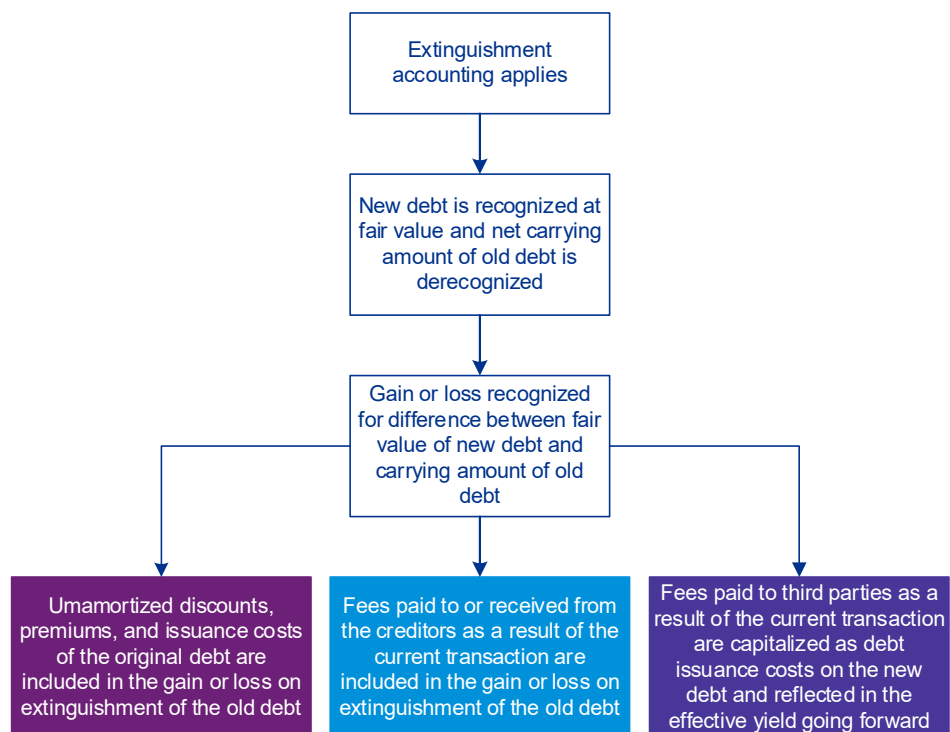
Extinguishment accounting and modification accounting are discussed in sections 4.5 and 4.6. This section focuses on which accounting model applies to a debt restructuring.



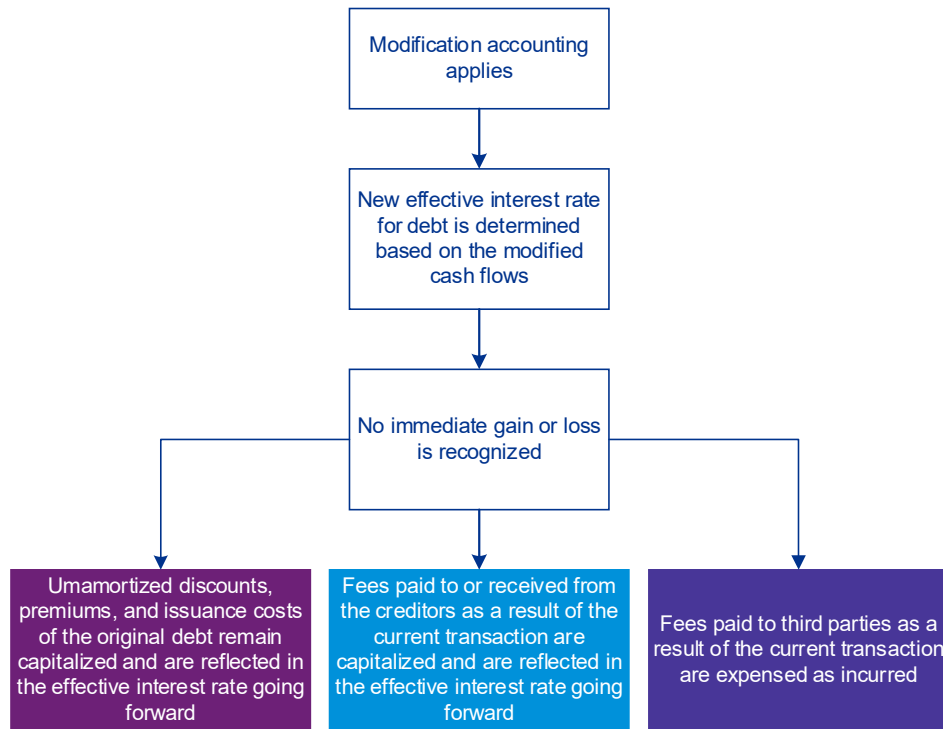
Question 4.4.10

How does a debtor determine if a debt restructuring is an extinguishment or modification of the original debt instrument?

Interpretive response: The analysis of whether a debt restructuring is considered to be a modification or an extinguishment depends on whether the old debt and the new debt have substantially different terms. If the terms are substantially different, the modification or exchange is accounted for as a debt extinguishment. Otherwise, it is accounted for as a modification. [470-50-40-6]



4. TDRs, debt modifications and extinguishments



4.4.20 Scope of Subtopic 470-50



Excerpt from ASC 470-50

05-1 This Subtopic discusses the accounting for all extinguishments of debt instruments, except debt that is extinguished through a **troubled debt restructuring** (see Subtopic 470-60) or a conversion of debt to equity securities of the debtor pursuant to conversion privileges provided in terms of the debt at issuance (see Subtopic 470-20).

05-2 This Subtopic also provides guidance on whether an exchange of debt instruments with the same creditor constitutes an extinguishment and whether a modification of a debt instrument should be accounted for in the same manner as an extinguishment.

05-3 In circumstances where an exchange of debt instruments or a modification of a debt instrument does not result in extinguishment accounting, this Subtopic provides guidance on the appropriate accounting treatment.

05-4 When debtors undergo a modification or exchange of a debt instrument, the resulting cash flows can be affected by changes in principal amounts, interest rates, or maturity. They can also be affected by fees exchanged between the debtor and creditor to effect changes in any of the following:

4. TDRs, debt modifications and extinguishments

- a. Recourse or nonrecourse features
- b. Priority of the obligation
- c. Collateralized (including changes in collateral) or noncollateralized features
- d. Debt covenants or waivers
- e. The guarantor (or elimination of the guarantor)
- f. Option features.

> Transactions

15-2 The guidance in this Subtopic applies, in part, to the following transactions and activities:

- a. Extinguishments of debt effected by issuance of common or preferred stock, including redeemable and fixed-maturity preferred stock, that do not represent the exercise of a conversion right contained in the terms of the debt at issuance.

15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Conversions of debt into equity securities of the debtor pursuant to conversion privileges provided in the terms of the debt at issuance. Additionally, the guidance in this Subtopic does not apply to conversions of convertible debt instruments pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. Guidance on conversions of debt instruments (including induced conversions) is contained in paragraphs 470-20-40-13 and 470-20-40-15.
- b. Extinguishments of debt through a **troubled debt restructuring**. (See Section 470-60-15 for guidance on determining whether a modification or exchange of debt instruments is a troubled debt restructuring. If it is determined that the modification or exchange does not result in a troubled debt restructuring, the guidance in this Subtopic shall be applied.)
- c. Transactions entered into between a debtor or a debtor's agent and a third party that is not the creditor.

> Other Considerations

15-4 The general guidance for the extinguishment of liabilities is contained in Subtopic 405-20 and defines transactions that the debtor shall recognize as an extinguishment of a liability.

> Extinguishment of Convertible Debt

40-5 The guidance in this Subtopic does not apply to debt tendered to exercise detachable warrants that were originally issued with that debt if the debt is permitted to be tendered towards the exercise price of the warrants under the terms of the securities at issuance. The tendering of the debt in such a case would be accounted for in the same manner as a conversion.

> Modifications and Exchanges

40-7 Transactions among debt holders do not result in a modification of the original debt's terms or an exchange of debt instruments between the debtor and the debt holders and do not impact the accounting by the debtor.

- > Debtor with a Binding Contract to Redeem Debt at a Future Date

55-8 This Subtopic applies to transactions in which the terms of a debt instrument are modified through execution of a binding contract between the debtor and creditor that requires a debt instrument to be redeemed at a future date for a specified amount.



Question 4.4.20

When is it appropriate to apply the accounting models in Subtopic 470-50?

Interpretive response: The accounting models for modifications and extinguishments of debt instruments are only applied if a debt restructuring is not a TDR (see section 4.2). [470-50-15-3(b)]

Further, a debt restructuring is analyzed under Subtopic 470-50 only when the old and new debt are with the same creditor. See section 4.7 for how the Subtopic is applied to arrangements with multiple creditors, such as loan participations and loan syndications.

This section only discusses the accounting treatment for nonconvertible and convertible debt instruments that are modified or exchanged for other instruments. The accounting model for modifications and extinguishments of convertible debt is only applied if the conversion feature was not separated under Topic 815.

Section 4.10 discusses the accounting when an instrument is repurchased for cash or other assets. For the accounting treatment for convertible instruments that are settled through conversion or by induced conversion, see chapter 10.



Question 4.4.21^^

Is an exchange of convertible debt for convertible preferred shares treated as an extinguishment?

Interpretive response: We believe an exchange of convertible debt for equity-classified convertible preferred shares that does not occur under the original conversion terms of the debt generally would be accounted for as a debt extinguishment.

However, in some circumstances, a debtor's exchange of convertible debt for convertible preferred shares may involve an induced conversion if the preferred shares are subsequently converted into common shares shortly thereafter under enhanced conversion privileges that are exercisable for a limited period of time.

For example, assume a debtor has outstanding convertible debt with a principal amount of \$1,000 that it can convert into 100 common shares at any time (i.e. \$10 conversion price). The debtor exchanges that convertible debt instrument for a convertible preferred share with a \$1,000 stated amount that can be

converted into 150 common shares for a 15-day period after the exchange date and is convertible into 100 common shares thereafter. It may be appropriate for the issuer to recognize an inducement charge equal to the fair value of the 50 incremental common shares issued to holders that convert within the 15-day period following the exchange.

However, all facts and circumstances need to be considered in making that determination and we expect that such circumstances will be rare. See further guidance on induced conversions in section 10.8.

4.4.30 Unit of account

When there are multiple creditors involved in a debt arrangement, the guidance in Subtopic 470-50 is applied on a creditor-by-creditor basis. The terms for each creditor involved can be different, such that a debt restructuring may result in substantially different terms for one creditor but not for another. Similarly, when first assessing whether the restructuring is a TDR under Subtopic 470-60, one creditor may have been determined to have granted a concession and another not to have. Therefore, in certain circumstances in a restructuring involving multiple creditors, a loan with one creditor may be accounted for as a TDR, a loan with another creditor under modification accounting, and a loan with a third creditor under extinguishment accounting.

Section 4.7 discusses additional considerations when multiple creditors are involved, such as in a loan syndication.

4.4.40 Determining whether the terms are substantially different



Excerpt from ASC 470-50

> Modifications and Exchanges

40-10 From the debtor's perspective, an exchange of debt instruments between or a modification of a debt instrument by a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. If the terms of a debt instrument are changed or modified and the cash flow effect on a present value basis is less than 10 percent, the debt instruments are not considered to be substantially different, except in the following two circumstances:

- a. A modification or an exchange affects the terms of an embedded conversion option, from which the change in the **fair value** of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is at least 10 percent of the carrying amount of

4. TDRs, debt modifications and extinguishments

the original debt instrument immediately before the modification or exchange.

- b. A modification or an exchange of debt instruments adds a substantive conversion option or eliminates a conversion option that was substantive at the date of the modification or exchange. (For purposes of evaluating whether an embedded conversion option was substantive on the date it was added to or eliminated from a debt instrument, see paragraphs 470-20-40-7 through 40-9.)

40-11 With respect to the conditions in (a) and (b) in the preceding paragraph, this guidance does not address modifications or exchanges of debt instruments in circumstances in which the embedded conversion option is separately accounted for as a derivative under Topic 815 before the modification, after the modification, or both before and after the modification.

40-12 The following guidance shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test described in paragraph 470-50-40-10:

- a. The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification. For a modification or an exchange of a freestanding equity-classified written call option held by a creditor that is a part of or directly related to a modification or an exchange of an existing debt instrument held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)), an entity shall apply the guidance in paragraph 470-50-40-12A.
- b. If the original debt instrument or the new debt instrument has a floating interest rate, then the variable rate in effect at the date of the exchange or modification shall be used to calculate the cash flows of the variable-rate instrument.
- c. If either the new debt instrument or the original debt instrument is callable or puttable, then separate cash flow analyses shall be performed assuming exercise and nonexercise of the call or put. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10 percent threshold is met.
- d. If the debt instruments contain contingent payment terms or unusual interest rate terms, judgment shall be used to determine the appropriate cash flows.
- e. The discount rate to be used to calculate the present value of the cash flows is the effective interest rate, for accounting purposes, of the original debt instrument.
- f. If within a year of the current transaction the debt has been exchanged or modified without being deemed to be substantially different, then the debt terms that existed a year ago shall be used to determine whether the current exchange or modification is substantially different.
- g. The change in the fair value of an embedded conversion option resulting from an exchange of debt instruments or a modification in the terms of an existing debt instrument shall not be included in the 10 percent cash flow test. Rather, a separate test shall be performed by comparing the change in the fair value of the embedded conversion option to the carrying amount

of the original debt instrument immediately before the modification, as specified in paragraph 470-50-40-10(a).

40-12A If a modification or an exchange of a freestanding equity-classified written call option held by a creditor is a part of or directly related to a modification or an exchange of an existing debt instrument held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)), an increase or a decrease in the fair value of the freestanding equity-classified written call option held by the creditor, calculated in accordance with paragraph 815-40-35-16, shall be included in the application of the 10 percent cash flow test described in paragraph 470-50-40-10.

If after a debt restructuring, the terms of the old and new debt are substantially different, the restructuring is accounted for as a debt extinguishment. Otherwise, it is accounted for as a modification. [470-50-40-6]



Question 4.4.30

How does a debtor determine whether the terms are substantially different?

Interpretive response: In determining whether the terms in the old and new debt after a debt restructuring are substantially different from the original debt agreement, the debtor performs a comparative test(s).

Does not involve convertible debt

If the modification or exchange does not involve convertible debt, a cash flow test is performed by comparing:

- the present value of the cash flows of the original instrument (generally the carrying amount of the original debt instrument)
- to
- the present value of the cash flows of the new instrument discounted at the effective interest rate (for accounting purposes) of the original debt instrument.

If the present value of the cash flows of the new debt instrument differs by at least 10% from the present value of the cash flows of the original debt instrument, the terms are considered to be substantially different, and the debtor applies extinguishment accounting. [470-50-40-10, 40-12]

Multiple cash flow tests may be needed if there are certain prepayment features where the debt is callable by the debtor or puttable by the creditor. See Questions 4.4.90 to 4.4.110, and Example 4.4.30.

If this cash flow test is not met, the debtor applies modification accounting.

Involves convertible debt

If a modification or exchange involves convertible debt, the debtor performs three separate analyses (in any order).

Analysis	Description
Analysis #1 Cash flow test	The terms of the new debt instrument are substantially different from those of the old debt and the issuer applies extinguishment accounting if: [470-50-40-10, 40-12(g)] <ul style="list-style-type: none"> — The present value of the cash flows under the terms of the new debt instrument (discounted at the effective interest rate of the original debt instrument) <p>Differs by $\geq 10\%$ from</p> <ul style="list-style-type: none"> — The present value of the remaining cash flows under the terms of the original instrument.
Analysis #2 Conversion option fair value test	The terms of the new debt instrument are substantially different from those of the old debt and the issuer applies extinguishment accounting if: [470-50-40-10(a)] <ul style="list-style-type: none"> — The change in the fair value of the embedded conversion option (difference in fair value of embedded conversion option immediately before and after the modification or exchange) <p>Is at least 10% of</p> <ul style="list-style-type: none"> — The carrying amount of the original debt instrument immediately before the modification or exchange.
Analysis #3	The terms of the new debt instrument are substantially different from those of the old debt and the issuer applies extinguishment accounting if a modification (or exchange): [470-50-40-10(b)] <ul style="list-style-type: none"> — adds a substantive conversion option; or — eliminates a conversion option that was substantive at the date of the modification (or exchange). <p>Section 10.7.40 discusses what constitutes a substantive conversion option.</p>

If any of those analyses results in a conclusion that the new debt instrument has substantially different terms from the original debt instrument, extinguishment accounting is required. However, if the new debt instrument does not have substantially different terms from the original debt instrument under any of those analyses, the debtor applies modification accounting.

Judgment needs to be exercised in certain debt restructurings where the value of the debt component and the conversion option component are simultaneously modified without substantially affecting the value of the overall instrument.

For example, this occurs when the value of the conversion option is decreased while simultaneously the value of the debt component is increased but the overall value of the convertible instrument is not significantly changed. In these circumstances, applying any one of the three analyses may result in a conclusion that the terms are substantially different.

However, we believe judgment should be exercised in understanding the overall purpose and relevant facts and circumstances of the modification to determine the appropriate conclusion. For example, whether recognizing a gain on extinguishment that results solely from a shift in the value of the debt component and the conversion option component is appropriate.

The above analyses do not apply when an embedded conversion option is separately accounted for as a derivative under Topic 815 before and/or after a modification (see Question 4.4.40). [470-50-40-10 – 40-11]



Question 4.4.40#

What factors are relevant when a conversion option or other feature in the original debt instrument is separately recognized as a derivative?

Interpretive response: Subtopic 470-50 indicates that Analysis #2 and Analysis #3 (Question 4.4.30) do not address modifications or exchanges of convertible debt where the conversion option has been bifurcated from the debt instrument and separately recognized as a derivative either before and/or after the modification or exchange. See Question 9.3.240 to determine whether a conversion option is bifurcated from a convertible debt instrument. [470-50-40-11]

Subtopic 470-50 does not provide guidance on the appropriate method for evaluating whether a modification or exchange of a convertible debt instrument with a bifurcated conversion feature is substantial, thereby warranting extinguishment accounting. However, we believe the following are acceptable approaches for evaluating whether the terms of a modified or exchanged debt instrument are substantially different. In addition, the debtor should evaluate the specific facts and circumstances of the modification or exchange, including understanding of the economics of the modification.

Conversion option before the modification or exchange:	Conversion option after the modification or exchange:	
	Bifurcated	Not bifurcated
Bifurcated	<p>Apply the 10% cash flow test – Analysis #1 – to the debt instrument only (without the conversion feature). If it is greater than 10%, extinguishment accounting applies.</p> <p>Recognize any change in fair value of the bifurcated conversion option in earnings and analyze the appropriate classification within the income statement.</p>	<p>Apply the 10% cash flow test – Analysis #1 – to the debt instrument; and</p> <p>Apply the 10% conversion option fair value test – Analysis #2 – for the change in fair value of the conversion option in relation to the carrying amount of the original debt instrument.</p> <p>If either test is met, extinguishment accounting applies.¹</p>
Not bifurcated	<p>Apply the 10% cash flow test – Analysis #1 – to the debt instrument; and</p> <p>Apply the 10% conversion option fair value test – Analysis #2 – for the change in fair value of the conversion option in relation to the carrying amount of the</p>	Not applicable

Conversion option before the modification or exchange:	Conversion option after the modification or exchange:	
	Bifurcated	Not bifurcated
	original debt instrument (before bifurcation). If either test is met, then extinguishment accounting applies. ¹	
<p>Note:</p> <p>1. Alternatively, a debtor may conclude that based on facts and circumstances, the terms of the debt instruments are substantially different as a result of the change in the accounting for the conversion option without performing the 10% tests (Analysis #3). This accounting policy should be applied consistently.</p>		



Question 4.4.50

How are the 'substantially different' analyses performed for convertible debt with a separately recognized equity component?

Interpretive response: Subtopic 470-50 does not specifically provide guidance on how to determine whether the terms are substantially different for convertible debt with a separately recognized equity component, i.e. a substantial premium. We believe the approaches outlined in the following table are reasonable.

Analysis	Factors to consider	Acceptable approach
Analysis #1 (cash flow test) – see Question 4.4.30	Effective interest rate	The original effective interest rate derived after separating the equity component, i.e. the rate used for accounting purposes.
Analysis #2 (change in fair value of the conversion option test) – see Question 4.4.30	Carrying amount of the original debt	The carrying amount of the original debt prior to separation of an equity component. This approach analyzes the significance of the change in fair value of the conversion option in relation to the carrying amount of the entire convertible debt instrument initially issued.

Analysis #3 (Question 4.4.30) is consistently applied to all convertible debt instruments with an equity component because it considers whether a substantive conversion option was eliminated or added as a result of the modification or exchange.



Question 4.4.60

What factors does a debtor consider when performing the cash flow test?

Interpretive response: The present value of the cash flows from the original debt is generally equal to its carrying amount because the contractual cash flows of the original debt are discounted at the debt's original effective interest rate.

In performing the cash flow test, the debtor considers the following factors.

- **Amount paid to or received from the creditor.** The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification. See Questions 4.4.70 and 4.4.80. [\[470-50-40-12\(a\)\]](#)
- **Freestanding equity-classified written call options.** The cash flow test includes the difference (increase or decrease) in fair value of a freestanding equity-classified written call option (e.g. a warrant) immediately before and after a modification or exchange if the option is: [\[470-50-40-12\(a\), 40-12A\]](#)
 - in the scope of paragraphs 815-40-35-14 to 35-17 (see section 8.13.40);
 - part of or directly related to the debt modification; and
 - held by the creditor.
- **Floating interest rate.** If either debt has a floating interest rate, the variable rate in effect at the date of the exchange or modification is used to calculate the debt's cash flows. [\[470-50-40-12\(b\)\]](#)
- **Prepayment features.** If either debt has a prepayment feature (e.g. call or put option), the debtor performs separate cash flow analyses for that debt assuming exercise and nonexercise of the prepayment option. The cash flow assumption that generates the smaller change in cash flows is used to determine the cash flows of the debt with the prepayment feature. See Questions 4.4.90 and 4.4.100, and Example 4.4.30. [\[470-50-40-12\(c\)\]](#)
- **Contingent payment features.** If the debt instruments contain contingent payment terms or unusual interest rate terms, judgment is needed to determine the appropriate cash flows. See Question 4.4.110. [\[470-50-40-12\(d\)\]](#)
- **Discount rate.** The discount rate to be used to calculate the present value of the cash flows is the effective interest rate, for accounting purposes, on the original debt instrument. [\[470-50-40-12\(e\)\]](#)
- **Multiple exchanges or modifications within a year.** If within a year of the current transaction the debt has been exchanged or modified without being deemed to be substantially different, the debt terms that existed a year ago are used to determine whether the current exchange or modification is substantially different. See Example 4.4.40. [\[470-50-40-12\(f\)\]](#)
- **Embedded conversion features.** If either the original or new debt instrument contain an embedded conversion option, the change in the fair value of the conversion option resulting from the modification or exchange is not included in the cash flow test. See Question 4.4.30. [\[470-50-40-12\(g\)\]](#)



Question 4.4.70
How do fees paid to third parties affect the cash flow test?

Interpretive response: Fees paid to third parties other than the lender at the time of the debt restructuring are not included in the cash flows of either the original debt instrument or the new debt instrument when performing the cash flow test. [470-50-40-12(a)]

However, third-party debt issuance costs are accreted using the effective interest method and are generally presented as a component of interest expense in the financial statements. Therefore, it is not clear whether the rate used to discount the cash flows in the cash flow test (i.e. the effective interest rate, for accounting purposes, of the original debt instrument) should include the effects of debt issuance cost amortization on the original debt instrument.

We believe that the use of an effective interest rate that either includes or excludes the effects of third-party debt issuance cost amortization on the original debt instrument is an accounting policy election that a debtor should apply consistently when performing the cash flow test.



Question 4.4.80
Does a debtor treat the creditor's costs that the debtor pays directly to third parties as fees paid to the creditor or to third parties?

Interpretive response: Fees paid to the creditor. In some debt restructuring transactions, the debtor agrees to directly pay certain or all of the creditor's costs (e.g. debtor will bear the creditor's attorney fees). Typically this is done as a matter of convenience for the creditor and is in lieu of paying a greater fee directly to the creditor.

Generally, we believe costs of the creditors paid directly by the debtor should be treated as if they were a fee directly paid by the debtor to the creditor as opposed to being treated as a third-party issuance cost. The debtor should treat creditor costs it paid directly to a third party as a fee paid to the creditor when assessing whether a modification is substantial (see section 4.4) and accounting for the fee.



Example 4.4.10
Modification of debt instrument is substantial – no prepayment feature

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and matures on December 31, Year 5.
- The interest rate is 8%, payable annually on December 31.
- The debt agreement does not include prepayment features.

4. TDRs, debt modifications and extinguishments

- Debtor pays a \$30,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$20,000 of third-party debt issuance costs.

Debtor records the borrowing and related third-party debt issuance costs as of January 1, Year 1 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	970,000	
Loan payable (discount – origination fee paid)	30,000	
Loan payable		1,000,000
<i>To recognize debt and related issuance costs.</i>		
Loan payable (debt issuance costs)	20,000	
Cash		20,000
<i>To recognize third-party issuance costs.</i>		

Accretion of debt discount and debt issuance costs

Debtor accretes the \$30,000 debt discount and the \$20,000 debt issuance costs using the effective interest method over the five-year term of the borrowing. From January 1, Year 1 to December 31, Year 4, Debtor accretes approximately \$25,000 of the debt discount and \$16,000 of the third-party debt issuance costs into interest expense.

Modification of debt

On January 1, Year 5, Debtor and Bank modify the terms of the debt as follows.

- Debtor pays a \$10,000 modification fee to Bank and incurs \$13,000 of third-party costs in connection with the modification.
- The interest rate is increased from 8% to 12%.
- The maturity date is extended by four years, to December 31, Year 9.

The fair value of the new debt instrument on January 1, Year 5 is \$1,035,000. Debtor concludes that this modification does not represent a TDR.

Immediately before the modification, the net carrying amount of the debt is as follows.

Par value of debt	\$1,000,000
Unaccreted discount on the loan	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Total future cash flows (undiscounted)	\$ 991,000

Analysis of modification

Debtor is required to schedule out all of the contractual cash flows under the new debt instrument, including cash paid to or received from Bank on the modification date. The cash flows, which exclude third-party costs, are as follows.

4. TDRs, debt modifications and extinguishments

Modification fee	\$ 10,000
Interest payments (\$1,000,000 × 12% × 5 years)	600,000
Repayment of principal	1,000,000
Total future cash flows	<u>\$ 1,610,000</u>

Debtor is required to discount the future cash flows using the effective interest rate of the original debt instrument, which was 8.77% (rounded). Debtor's accounting policy is to use the effective interest rate of the original debt instrument excluding the third-party debt issuance costs when performing the cash flow test.

Year	Mod. fee ¹	Interest payments	Principal payments	Total cash flows	Discounted cash flows ²
Jan 1 Yr 5	\$10,000			\$ 10,000	\$ 10,000
Yr 5		\$120,000		120,000	110,000
Yr 6		120,000		120,000	101,000
Yr 7		120,000		120,000	93,000
Yr 8		120,000		120,000	86,000
Yr 9		120,000	\$1,000,000	1,120,000	736,000
Total	<u>\$10,000</u>	<u>\$600,000</u>	<u>\$1,000,000</u>	<u>\$1,610,000</u>	<u>1,136,000</u>
Carrying amount of original debt ³					(995,000)
Change					<u><u>\$ 141,000</u></u>

Notes:

1. Fee paid on January 1, Year 5 (date of modification) and therefore not discounted.
2. Discounted at the effective interest rate of 8.77%. The results are rounded to the nearest thousand.
3. Excludes unaccreted third-party issuance costs in accordance with Debtor's accounting policy.

The increase of \$141,000 (14.2%) over the \$995,000 present value of the cash flows under the original debt instrument is greater than 10%. Therefore, Debtor concludes that the terms of the new debt instrument are substantially different and applies extinguishment accounting to the old debt (see section 4.5).



Example 4.4.20

Modification of debt instrument is not substantial – no prepayment feature

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and matures on December 31, Year 5.
- The interest rate is 8%, payable annually on December 31.
- The debt agreement does not include prepayment features.

4. TDRs, debt modifications and extinguishments

- Debtor pays a \$30,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$20,000 of third-party debt issuance costs.

Debtor records the borrowing and related debt issuance costs as of January 1, Year 1 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	970,000	
Loan payable (discount on loan payable)	30,000	
Loan payable		1,000,000
<i>To recognize debt and related issuance costs.</i>		
Loan payable (debt issuance costs)	20,000	
Cash		20,000
<i>To recognize third-party issuance costs.</i>		

Accretion of debt discount and debt issuance costs

Debtor accretes the \$30,000 debt discount and the \$20,000 of debt issuance costs using the effective interest method over the five-year term of the borrowing. From January 1, Year 1 to December 31, Year 4, Debtor accretes approximately \$25,000 of the debt discount and \$16,000 of the debt issuance costs into interest expense.

Modification of debt

On January 1, Year 5, Debtor and Bank modify the terms of the debt as follows.

- Debtor pays a \$10,000 modification fee to Bank.
- The interest rate is increased from 8% to 10%.
- The maturity date is extended two years, to December 31, Year 7.

Debtor incurs \$13,000 of third-party costs in connection with the modification.

Debtor concludes that this modification does not represent a TDR.

Immediately before the modification, the net carrying amount of the debt is as follows.

Par value of debt	\$ 1,000,000
Unaccreted discount on debt	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	\$ 991,000

Analysis of modification

Debtor schedules out all of the contractual cash flows under the new debt instrument, including cash paid to or received from the lender on the modification date. The cash flows, which exclude third-party costs, are as follows.

4. TDRs, debt modifications and extinguishments

Modification fee	\$ 10,000
Interest payments (\$1,000,000 × 10% × 3 years)	300,000
Repayment of principal	1,000,000
Total future cash flows	\$ 1,310,000

Debtor discounts the cash flows using the effective interest rate of the original debt instrument, which was 8.77% (rounded). Debtor's accounting policy is to use the effective interest rate of the original debt instrument excluding the third-party debt issuance costs when performing the cash flow test. However, Debtor does not discount the \$10,000 modification fee because it was paid on the modification date.

Present value of cash flows of new debt ¹	\$1,041,000
Present value of cash flows of original debt ²	(995,000)
Difference	\$ 46,000
	Change
Change in cash flows: $(\$1,041,000 - \$995,000) \div \$995,000$	4.6%
Notes:	
1. Discounted at the 8.77% effective interest rate of the original debt.	
2. Calculated as \$1 million principal amount – \$5,000 unaccreted discount; debt issuance costs are excluded per policy election.	

Because the change is less than 10%, Debtor concludes that the terms of the new debt instrument are not substantially different and applies modification accounting to the old debt (see section 4.6).



Question 4.4.90

How many cash flow analyses does the debtor perform when a prepayment option exists?

Interpretive response: If prepayment options exist in both the original and new debt instrument, the cash flow analysis typically involves calculating four separate cash flows: [470-50-40-12(c)]

- cash flows assuming the original debt and the new debt are not prepaid;
- cash flows assuming the original debt is immediately prepaid, but the new debt is not prepaid; see Question 4.4.110 when debt terms contain contingent payments;
- cash flows assuming the original debt is not prepaid, but the new debt is immediately prepaid; and
- cash flows assuming the original debt and the new debt are both immediately prepaid.

The present value of the cash flows will not equal the carrying amount of the existing debt in some scenarios.

Under this guidance, the cash flow assumptions that generate the smallest change compared to the original carrying amount are the basis for determining whether the cash flow test has been met.

This last assumption (that both debts are immediately prepaid) generally results in the smallest change in cash flows. Therefore, in practice debtors generally will first calculate the cash flows assuming both the original debt and new debt are prepaid. If the difference between the present values of the two resulting cash flows is less than 10%, there is no need to calculate the other cash flow scenarios because the cash flow test will not be met, and modification accounting will apply.

If the terms of the debt provide for prepayment options that are only effective as of a certain date in the future (i.e. with the passage of time) or the prepayment amounts vary with the passage of time, we believe prepayment should be assumed as of that date or those various dates in the above cash flow analysis.



Question 4.4.100

Does the debtor's financial inability to exercise a prepayment option affect the cash flow test?

Interpretive response: No. When either the old debt instrument, the new debt instrument or both, is prepayable, we believe that separate cash flow analyses should be performed, assuming exercise or nonexercise of the call or put, regardless of the debtor's financial ability to prepay the instrument at the modification date. Specifically, we believe the cash flow test generally should be performed based on the contractual terms of the instrument, regardless of the debtor's financial wherewithal to repay the debt at maturity or on earlier prepayment dates. However, if a nonsubstantive prepayment feature is added to the terms of a new debt instrument solely to affect the outcome of the cash flow test, then the prepayment feature is disregarded.



Question 4.4.110

How does a contingently exercisable prepayment option affect the cash flow test?

Interpretive response: For contingently exercisable prepayment options, judgment may be necessary in determining the periods of cash flows to use in the cash flow test to determine whether a modification or exchange is substantial. When a contingency permitting the debtor or creditor to exercise a prepayment option is not substantive, we believe it generally is appropriate to assume that the contingent prepayment option will not be exercised when performing the cash flow test.



Example 4.4.30

Modification of a debt instrument with prepayment features

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and matures on December 31, Year 5.
- The interest rate is 8%, payable annually on December 31.
- Debtor may prepay the debt for its \$1 million par value at any time after December 31, Year 3.
- Debtor pays a \$30,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$20,000 of third-party debt issuance costs.

Debtor records the borrowing and related debt issuance costs as of January 1, Year 1 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	970,000	
Loan payable (discount on loan payable)	30,000	
Loan payable		1,000,000
<i>To recognize debt and related issuance costs.</i>		
Loan payable (debt issuance costs)	20,000	
Cash		20,000
<i>To recognize third-party issuance costs.</i>		

Accretion of debt discount and debt issuance costs

Because Debtor has the ability to repay the debt at any time, it elects to accrete/amortize any discounts/premiums and issuance costs over the stated term (not the estimated life) of the debt. See section 3.4.30.

Debtor accretes the \$30,000 debt discount and the \$20,000 debt issuance costs using the effective interest method over the five-year term of the borrowing. From January 1, Year 1 to December 31, Year 4, Debtor accretes approximately \$25,000 of the debt discount and \$16,000 of the third-party debt issuance costs into interest expense.

Modification of debt

On January 1, Year 5, Debtor and Bank modify the terms of the debt as follows.

- Debtor pays a \$10,000 modification fee to Bank and incurs \$13,000 of third-party costs in connection with the modification.
- The interest rate is increased from 8 to 12%.
- The maturity date is extended by four years, to December 31, Year 9.
- Debtor may prepay the debt for its \$1 million par value at any time.

Debtor concludes that this modification does not represent a TDR.

Immediately before the modification, the following amounts are relevant.

Par value of debt	\$ 1,000,000
Unaccreted discount on the loan	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	\$ 991,000

Analysis of modification

To perform the cash flow test, Debtor schedules out all of the contractual cash flows under the new debt instrument, including any cash paid to or received from the lender on the modification date. Because the debt instruments contain prepayment features, Debtor performs separate cash flow analyses for each instrument assuming exercise and nonexercise of the prepayment option. It uses the cash flow assumptions that generate the least change to determine whether the 10% threshold is met.

Debtor could elect to immediately prepay both the original debt instrument and the new debt instrument for their \$1 million par value on the modification date. It would also have to pay a \$10,000 modification fee, which represents a cash outflow on the new debt instrument. It computes the cash flow test assuming a prepayment as follows.

	Original	Modified
Par value	\$1,000,000	\$1,000,000
Modification fee	-	10,000
Cash outflows	\$1,000,000	\$1,010,000
		Change
Change in cash flows: $(\$1,010,000 - \$1,000,000) \div \$1,000,000$		1%

These cash flow amounts are not discounted because they assume the immediate prepayment of the debt instruments on the modification date. The unaccreted portion of the original debt discount or issuance costs are not contemplated in the cash flow analysis because they do not represent a future cash flow as of the date of modification.

Because the change in cash flows assuming prepayment at the earliest possible date is less than 10% (i.e. only 1%), Debtor need not determine the cash flows assuming a no prepayment scenario. It concludes that because the cash flow test is not met, there has been no substantial modification, and it applies modification accounting (see section 4.6).



Example 4.4.40

Separate modifications occurring within a year for the same debt instrument

Assume the same fact pattern as Example 4.4.30, but in addition to the January, Year 5 modification, there is another modification of the same debt on

July 1, Year 5. In this second modification, Debtor pays an additional \$15,000 modification fee to Bank, with modifications to the debt as follows:

- the interest rate is decreased from 12% to 11%; and
- the instrument can still be prepaid at any time, but the modified terms now include a penalty of 1% of the par value.

Debtor incurs \$8,000 of third-party costs in connection with the modification.

Debtor concludes that this modification does not represent a TDR.

Analysis of modification

In Example 4.4.30, Debtor determined that the first modification did not meet the cash flow test, meaning the modified debt was not substantially different than the original debt issued on January 1, Year 1. In this Example, Debtor performs the cash flow test on the current modification and therefore needs to determine if the terms of the original and modified debt instruments are substantially different. Because the debt has been modified within one year of the current modification without being deemed to be substantially different, the debt terms that existed prior to the first modification are used in the cash flow test. Therefore, Debtor combines the January and July, Year 5 modifications to determine if together these two modifications resulted in more than a 10% change in cash flows as compared to the original debt.

Debtor calculates the change in cash flows as follows.

	Original	Modified
Prepayment of debt	\$1,060,000 ¹	\$1,000,000
Prepayment penalty (1% × \$1 million)	-	10,000
Lender fees paid on January 1, Year 5		10,000
Lender fees paid on July 1, Year 5	-	15,000
Cash outflows	\$1,060,000	\$1,035,000
		Change
Change in cash flows: $(\$1,060,000 - \$1,035,000) \div \$1,060,000$		2.4%
Note:		
1. Principal and accrued interest of \$60,000 at 12% through July 1.		

Because the change in cash flows is less than 10%, Debtor concludes the modification is not substantial and does not apply extinguishment accounting.

Because the modification is not substantial, the \$15,000 modification fee paid to Bank is reflected in determining the effective interest rate on the new instrument. Debtor continues to accrete the unaccreted third-party debt issuance costs related to the original borrowing as of the modification date using the effective interest method over the remaining term of the new debt instrument. However, the \$8,000 of third-party costs related to the modification are expensed as incurred because the modification is not substantial. Debtor determines a new effective interest rate on the debt based on the increased debt discount and decreased interest rate. See section 4.6 for further information relating to the application of modification accounting.

4.4.50 Applying the cash flow test when there is a change in the principal amount

In connection with the modification or exchange of debt instruments with a creditor, often the debtor and creditor agree to modify their contractual rights to either increase or decrease the principal amount of the previously existing debt instrument. A question arises in practice as to whether the debtor should use the gross method or the net method to assess the cash flows of the instruments when applying the cash flow test described in section 4.4.40.

Gross method	Net method
Under the gross method, the debtor includes the cash flows associated with the increase (cash inflow) or decrease (cash outflow) when applying the cash flow test to determine whether the modified or exchanged debt instrument is substantially different than the original instrument.	Under the net method, the debtor excludes increases and decreases in the principal amount from the cash flow test by treating increases (cash inflows) in principal as new borrowings and decreases (cash outflows) as partial extinguishments of the previously existing debt instrument.



Question 4.4.120

Between the gross and net methods, is one preferred over the other?

Interpretive response: Yes. We understand the SEC staff currently believes the gross method is generally the appropriate method to evaluate whether a modification or exchange of a debt instrument is substantial under the cash flow test.

However, in rare, limited and unusual circumstances in which the gross method produces a result that inappropriately ignores the economic substance of the transaction, we believe it may be appropriate to apply the net method, after due consideration of all the facts and circumstances. For example, if the change in principal is significant, the gross method can result in an unusually high or low off-market effective interest rate for the modified debt if there was a significant premium or discount associated with the old debt and the cash flow change was less than 10%. In this instance, applying the net method may be appropriate regardless of the debtor's accounting policy for modifications or exchanges involving smaller changes in the principal amount.



Question 4.4.130

When are cash flows associated with an increase or decrease in principal included in the cash flow test?

Background: When restructuring a debt, a debtor may decrease the principal amount by exercising its existing contractual rights under the debt's terms – e.g. the debtor had the right to prepay any portion of the previously existing debt instrument at a stated premium.

In other circumstances a debtor may decrease the principal amount by modifying its existing contractual rights – e.g. under the debt’s terms the debtor had the right to prepay any portion of the previously existing debt instrument at a stated premium, but the debtor and creditor modify those terms to permit the current prepayment to be at par.

Lastly, a debtor may agree with its creditor to increase the principal amount of the previously existing debt.

Interpretive response: If the debtor decreases the principal amount by exercising its contractual rights under the terms of the existing debt, we believe the decrease in principal amount should be treated as a partial extinguishment of the previously existing debt instrument with a proportionate amount of unaccreted/unamortized discount or premium and third-party debt issuance costs recognized in earnings.

In contrast, when a debtor decreases the principal amount by modifying its existing contractual rights, we generally believe the decrease in principal (cash outflow) should be included in the cash flow test as a day one cash outflow. However, it may be appropriate to exclude the change in principal from the cash flow test when:

- there is a significant reduction in principal amount; or
- application of the cash flow test results in an effective interest rate for the modified or exchanged debt instrument that is significantly different from current market rates (see Question 4.4.120).

If the debtor agrees to increase the principal as part of a modification or exchange of a debt instrument, generally we believe the increase (cash inflow) should be included in the debtor’s cash flow test as a day one cash inflow under paragraph 470-50-40-10.



Example 4.4.50

Modification-date cash inflow increases the principal amount – incremental borrowing

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and matures on December 31, Year 5.
- The interest rate is 8%, payable annually on December 31.
- The debt instrument does not include prepayment features. Debtor also pays a \$30,000 origination fee to Bank at the issuance date and \$20,000 of third-party debt issuance costs.

Debtor records the following journal entries on the issuance date.

	<i>Debit</i>	<i>Credit</i>
Cash	970,000	
Loan payable (discount – origination fee paid)	30,000	
Loan payable		1,000,000
<i>To recognize debt and related issuance costs.</i>		
Loan payable (debt issuance costs)	20,000	
Cash		20,000
<i>To recognize third-party issuance costs.</i>		

Accretion of debt discount and debt issuance costs

Debtor accretes the \$30,000 debt discount and the \$20,000 of third-party debt issuance costs using the effective interest method over the five-year term of the borrowing. From January 1, Year 1 to December 31, Year 4, Debtor accretes approximately \$25,000 of the debt discount and \$16,000 of the third-party debt issuance costs into interest expense.

Modification of debt

On January 1, Year 5, Debtor and Bank modify the terms of the previously existing debt instrument as follows.

- The principal amount is increased from \$1 million to \$1.3 million.
- Debtor pays a \$10,000 modification fee to Bank.
- The interest rate is increased from 8% to 9%.
- The maturity date is extended by four years, to December 31, Year 9.

Further, Debtor incurs \$13,000 of third-party debt issuance costs in connection with the modification.

Debtor concludes that this modification does not represent a TDR.

Immediately before this modification, the net carrying amount of the debt is as follows.

Par value of debt	\$ 1,000,000
Unaccreted discount on the loan	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	\$ 991,000

Applying the gross method

Under the gross method, Debtor schedules out all of the contractual cash flows under the new debt instrument, including cash paid to or received from the lender on the modification date. The cash flows, which exclude third-party debt issuance costs, are as follows.

4. TDRs, debt modifications and extinguishments

Increase in principal (cash inflow) ¹	\$ (300,000)
Modification fee	10,000
Interest payments ($\$1,300,000 \times 9\% \times 5$ years)	585,000
Repayment of principal	1,300,000
Total future cash flows	\$1,595,000
Note:	
1. \$1.3 million principal on new debt – \$1 million principal on original debt.	

Debtor discounts these cash flows using the effective interest rate of the original debt instrument, which was 8.77% (rounded). (Note: Debtor's accounting policy is to use the effective interest rate of the original debt instrument excluding the third-party debt issuance costs when performing the cash flow test; see Question 4.4.70.)

Present value of cash flows of new debt ¹	\$1,022,000
Present value of cash flows of original debt ²	(995,000)
Difference	\$ 27,000
	Change
Change in cash flows: $(\$1,022,000 - \$995,000) \div \$995,000$	2.7%
Notes:	
1. Discounted at the 8.77% effective interest rate of the original debt. Debtor does not discount the \$290,000 (\$300,000 increase in principal – \$10,000 modification fee) net cash inflow on January 1, Year 5 because it was received on the modification date.	
2. Calculated as \$1 million principal amount – \$5,000 unaccreted discount; debt issuance costs are excluded per policy election.	

Debtor concludes that the terms of the new debt instrument are not substantially different, and therefore applies modification accounting (see section 4.6).



Example 4.4.60

Modification-date cash outflow decreases the principal amount – partial repayment with no prepayment features

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and matures on December 31, Year 5.
- The interest rate is 8%, payable annually on December 31.
- The debt agreement does not include prepayment features.
- Debtor pays a \$30,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$20,000 of third-party debt issuance costs.

Debtor records the borrowing and related third-party debt issuance costs as of January 1, Year 1 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	970,000	
Loan payable (discount – origination fee paid)	30,000	
Loan payable		1,000,000
<i>To recognize debt and related issuance costs.</i>		
Loan payable (debt issuance costs)	20,000	
Cash		20,000
<i>To recognize third-party debt issuance costs.</i>		

Accretion of debt discount and debt issuance costs

Debtor accretes the \$30,000 debt discount and the \$20,000 of third-party debt issuance costs using the interest method over the five-year term of the borrowing. From January 1, Year 1 to December 31, Year 4, Debtor accretes approximately \$25,000 of the debt discount and \$16,000 of the third-party debt issuance costs into interest expense.

Modification of debt

On January 1, Year 5, Debtor and Bank modify the terms of the previously existing debt instrument as follows.

- The principal amount is reduced from \$1 million to \$700,000.
- Debtor pays a \$10,000 modification fee to Bank.
- The interest rate is increased from 8% to 9%.
- The maturity date is extended by four years to December 31, Year 9.

Further, Debtor incurs \$13,000 of third-party costs in connection with the modification.

Debtor concludes that this modification does not represent a TDR.

Immediately before the modification, the carrying amount of the debt is as follows.

Par value of debt	\$ 1,000,000
Unaccreted discount on the loan	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	\$ 991,000

Applying the gross method

Debtor schedules out all of the contractual cash flows under the new debt instrument, including cash paid to or received from the lender on the modification date. The cash flows, which exclude third-party debt issuance costs, are as follows.

4. TDRs, debt modifications and extinguishments

Decrease in principal ¹	\$ 300,000
Modification fee	10,000
Interest payments (\$700,000 × 9% × 5 years)	315,000
Repayment of principal	700,000
Total future cash flows	\$1,325,000
Note:	
1. \$1 million principal on original debt – \$700,000 principal on new debt.	

Debtor discounts these cash flows using the effective interest rate of the original debt instrument, which was 8.77% (rounded). (Note: Debtor's accounting policy is to use the effective interest rate of the original debt instrument excluding the amortization of third-party debt issuance costs when performing the cash flow test; see Question 4.4.70)

Present value of cash flows of new debt ¹	\$1,016,000
Present value of cash flows of original debt ²	(995,000)
Difference	\$ 21,000
	Change
Change in cash flows: $(\$1,016,000 - \$995,000) \div \$995,000$	2.1%
Notes:	
1. Discounted at the 8.77% effective interest rate of the original debt. Debtor does not discount the \$310,000 (\$300,000 decrease in principal + \$10,000 modification fee) net cash outflow on January 1, Year 5 because it was paid on the modification date.	
2. Calculated as \$1 million principal amount – \$5,000 unaccreted discount; debt issuance costs are excluded per policy election.	

Debtor concludes that the terms of the new debt instrument are not substantially different and therefore applies modification accounting. See section 4.6 for application of modification accounting.



Example 4.4.70

Modification-date cash outflow decreases the principal amount – partial repayment under contractual prepayment terms of original borrowing

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and bears interest at 8%, payable annually on December 31.
- Debtor may prepay the debt, in whole or in part, at any time at 102% of the principal amount prepaid.

4. TDRs, debt modifications and extinguishments

- Debtor pays a \$30,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$20,000 of third-party debt issuance costs.

Debtor records the borrowing and related third-party debt issuance costs as of January 1, Year 1 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	970,000	
Loan payable (discount – origination fee paid)	30,000	
Loan payable		1,000,000
<i>To recognize debt and related issuance costs.</i>		
Loan payable (debt issuance costs)	20,000	
Cash		20,000
<i>To recognize third-party issuance costs.</i>		

Accretion of debt discount and debt issuance costs

Because Debtor has the ability to repay the loan at any time, it elects to accrete/amortize any discounts/premiums and issuance costs over the stated term (not the estimated life) of the loan. See section 3.4.30.

Debtor accretes the \$30,000 debt discount and the \$20,000 debt issuance costs using the effective interest method over the five-year term of the borrowing. From January 1, Year 1 to December 31, Year 4, Debtor accretes approximately \$25,000 of the debt discount and \$16,000 of the third-party debt issuance costs into interest expense.

Modification of debt

On January 1, Year 5, Debtor decides to prepay \$300,000 of the principal amount under the contractual prepayment terms of the original borrowing, and Debtor and Bank modify the terms of the original loan as follows.

- The principal amount is reduced from \$1 million to \$700,000 and Debtor pays \$306,000 to Bank on the modification date: \$300,000 principal reduction plus 2% prepayment penalty.
- Debtor pays Bank a \$10,000 modification fee and incurs \$13,000 of third-party costs in connection with the modification.
- Debtor may prepay the modified debt, in whole or in part, at any time at 102% of the principal amount prepaid.
- The interest rate is increased from 8% to 9%.
- The maturity date is extended by four years, to December 31, Year 9.

Debtor concludes that this modification does not represent a TDR.

Immediately before the modification, the net carrying amount of the loan is as follows.

4. TDRs, debt modifications and extinguishments

Par value of debt	\$ 1,000,000
Unaccreted discount on the loan	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	\$ 991,000

Applying the net method*Partial extinguishment analysis*

Because the modification-date cash outflow was paid under the contractual prepayment terms of the original borrowing, Debtor accounts for that cash outflow (including the 2% prepayment penalty) and related decrease in the debt principal as a partial extinguishment of the original debt.

It then performs the cash flow test using the cash flows related to the remaining \$700,000 principal amount for the original debt instrument versus the cash flows related to the \$700,000 principal amount of the new debt instrument.

Debtor concludes that it incurred the \$10,000 modification fee paid to Bank and the \$13,000 of third-party costs related to the modification in connection with the modification to the terms of the \$700,000 ongoing borrowing.

Debtor calculates unaccreted discount related to the partial prepayment of principal as follows.

Partial principal prepayment	\$300,000
Unaccreted debt discount	\$ 5,000
Unaccreted third-party costs	\$ 4,000
Percentage of debt extinguished:	$\$300,000 \div \$1,000,000 = 30\%$
Proportionate unaccreted debt discount	$\$5,000 \times 30\% = \$ 1,500$
Proportionate unaccreted third-party costs	$\$4,000 \times 30\% = \$ 1,200$

Therefore, the net carrying amount of the extinguished debt and the gain/loss on partial extinguishment are calculated as follows.

Par value of debt	\$ 300,000
Unaccreted discount on debt	(1,500)
Unaccreted third-party debt issuance costs	(1,200)
Net carrying amount of debt	297,300
Payment for partial extinguishment	306,000
Loss on debt extinguishment	\$ (8,700)

4. TDRs, debt modifications and extinguishments

Debtor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Loan payable	300,000	
Loss on debt extinguishment	8,700	
Loan payable (discount on loan payable)		1,500
Loan payable (debt issue costs)		1,200
Cash		306,000
<i>To recognize partial extinguishment of debt and related loss.</i>		

Cash flow analysis

Next, Debtor performs the cash flow test using the cash flows related to the remaining \$700,000 principal amount for the original debt instrument versus the cash flows related to the \$700,000 principal amount of the new debt instrument.

Because the new debt instrument and the original debt instrument were prepayable, separate cash flow analyses are performed assuming exercise and nonexercise of the prepayment provisions to determine whether the debt instruments are substantially different. The cash flow assumptions that generate the smallest change are the basis for determining whether the cash flow test has been met.

While this analysis involves calculating four separate cash flow analyses because both the original debt instrument and the new debt instrument contain prepayment provisions (see Question 4.4.90), generally the smallest change in cash flows will result from assuming immediate prepayment of both the original and new debt instruments.

Therefore, Debtor first calculates the cash flows assuming both the original debt and new debt are immediately prepaid on January 1, Year 5. The amounts in the analysis are not discounted because they are assumed to be paid on the date of modification.

	Original	Modified
Principal amount	\$700,000	\$700,000
Modification fee	-	10,000
Prepayment penalty ¹	14,000	14,000
Cash outflows	<u>\$714,000</u>	<u>\$724,000</u>
		Change
Change in cash flows: $(\$724,000 - \$714,000) \div \$714,000$		1.4%
Note:		
1. The prepayment penalty is 2% on both the original and modified debt.		

Because the change in cash flows is less than 10%, Debtor concludes that the terms of the new debt instrument are not substantially different and applies modification accounting (see section 4.6).

Note: If this analysis had resulted in a conclusion that the debt instruments were substantially different, Debtor would have been required to consider the other potential cash flow analyses (i.e. assuming neither or only one of the debt instruments are prepaid) before concluding whether or not the debt instruments are substantially different.



Example 4.4.80

Modification-date cash outflow decreases the principal amount – partial repayment not under the contractual prepayment terms of original borrowing

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and bears interest at 8%, payable annually on December 31.
- Debtor may prepay the debt, in whole or in part, at any time at 102% of the principal amount prepaid.
- Debtor pays a \$30,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$20,000 of third-party debt issuance costs.

Debtor records the borrowing and related third-party debt issuance costs as of January 1, Year 1 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	970,000	
Loan payable (discount on loan payable)	30,000	
Loan payable		1,000,000
<i>To recognize debt and related issuance costs.</i>		
Loan payable (debt issuance costs)	20,000	
Cash		20,000
<i>To recognize debt and related issuance costs.</i>		

Accretion of debt discount and debt issuance costs

Because Debtor has the ability to repay the loan at any time, it elects to accrete/amortize any discounts/premiums and issuance costs over the stated term (and not the estimated life) of the loan. See section 3.4.30.

Debtor accretes the \$30,000 debt discount and the \$20,000 of third-party debt issuance costs using the effective interest method over the five-year term of the borrowing. From January 1, Year 1 to December 31, Year 4, Debtor accretes approximately \$25,000 of the debt discount and \$16,000 of the third-party debt issuance costs into interest expense.

Modification of debt

On January 1, Year 5, Debtor decides to prepay \$300,000 of the principal amount, and Debtor and Bank modify the terms of the loan as follows.

- The principal amount is reduced from \$1 million to \$700,000 but Debtor does not pay a prepayment penalty as required under the contractual terms of the original instrument (\$300,000 principal payment to Bank on the modification date).
- Debtor pays Bank a \$10,000 modification fee and incurs \$13,000 of third-party debt issuance costs in connection with the modification.
- Debtor may prepay the modified loan, in whole or in part, at any time at 102% of the principal amount prepaid.
- The interest rate is increased from 8% to 9%.
- The maturity date is extended by four years, to December 31, Year 9.

Debtor concludes that this modification does not represent a TDR.

Immediately before the modification, the net carrying amount of the loan is as follows.

Par value of debt	\$ 1,000,000
Unaccreted discount on debt	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	\$ 991,000

Applying the gross method

Because Debtor is not required to pay a penalty on the partial prepayment of the principal (as required by the contractual prepayment terms), the prepayment is not considered to be under the contractual prepayment feature of the debt instrument. Further, because the modification-date cash outflow is not paid under the contractual prepayment terms of the original borrowing, Debtor does not account for that cash outflow and related decrease in the debt principal as a partial extinguishment of the original debt.

Instead, it performs the cash flow test using the cash flows related to an assumed principal amount of \$1 million of the new debt instrument with a corresponding day 1 cash outflow on the new debt of \$300,000. Debtor concludes that it incurred the \$10,000 modification fee paid to Bank and the \$13,000 of third-party costs related to the modification in connection with the modification to the terms of the \$700,000 ongoing borrowing.

If either the new debt instrument or the original debt instrument is prepayable, then separate cash flow analyses are performed assuming exercise and nonexercise of the prepayment provisions to determine whether the debt instruments are substantially different (see Question 4.4.90). The cash flow assumptions that generate the smallest change are the basis for determining whether the cash flow test has been met.

While this analysis typically involves calculating four separate cash flow analyses if both the original debt instrument and the new debt instrument

4. TDRs, debt modifications and extinguishments

contain prepayment provisions, generally the smallest change in cash flows will result from assuming immediate prepayment of both the original and new debt instruments. Therefore, in practice debtors generally first calculate the cash flows assuming both the original debt and new debt are immediately prepaid for these purposes.

Debtor performs the cash flow test assuming immediate prepayment as follows.

	Original	Modified
Partial prepayment of principal	-	\$300,000
Remaining principal	\$1,000,000	700,000
Modification fee	-	10,000
Prepayment penalty	20,000	14,000
Cash outflows	\$1,020,000	\$1,024,000
		Change
Change in cash flows: $(\$1,024,000 - \$1,020,000) \div \$1,020,000$		0.4%

Debtor does not discount any of the above cash flows because they represent amounts that would be paid on the modification date. The original debt discount is not included in the cash flow analysis because it does not represent a future cash flow at the date of modification.

Because the change in cash flows is less than 10%, Debtor concludes that the terms of the new debt instrument are not substantially different and applies modification accounting (see section 4.6).



Example 4.4.90

Modification-date cash outflow significantly decreases the principal amount – partial repayment when use of net method may be appropriate

On January 1, Year 4, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and bears interest at 8%, payable annually on December 31.
- There are no prepayment features.
- Debtor pays a \$100,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount. There are no third-party debt issuance costs.

Debtor records the borrowing as of January 1, Year 4 in the following journal entry.

4. TDRs, debt modifications and extinguishments

	<i>Debit</i>	<i>Credit</i>
Cash	900,000	
Loan payable (discount on loan payable)	100,000	
Loan payable		1,000,000
<i>To recognize debt and related discount.</i>		

Accretion of debt discount

Debtor accretes the \$100,000 debt discount using the effective interest method over the five-year term of the borrowing. From January 1, Year 4 to December 31, Year 4, Debtor accretes approximately \$16,000 of the debt discount into interest expense.

Modification of debt

On January 1, Year 5, Debtor and Bank modify the terms of the loan as follows.

- The principal amount is reduced from \$1 million to \$200,000 and Debtor pays no modification fee to Bank, resulting in a total payment of \$800,000 to Bank on the modification date.
- The interest rate is unchanged at 8%.
- The maturity date is extended to December 31, Year 9.
- The new loan does not include prepayment features.

Debtor concludes that this modification does not represent a TDR.

Immediately before the modification, the net carrying amount of the debt is as follows.

Par value of debt	\$ 1,000,000
Unaccreted discount on debt	(84,000)
Net carrying amount of debt	\$ 916,000

Given the facts and circumstances of the debt modification, Debtor assesses whether the gross method ignores the economic substance of the transaction to the extent that the net method should be applied.

Applying the gross method

Under the gross method, Debtor is required to schedule all of the contractual cash flows under the new debt instrument, including cash paid to or received from the lender on the modification date that decreases or increases the principal amount.

The cash flows are as follows.

Principal payment on modification date (January 1, Year 5)	\$ 800,000
Interest payments ($\$200,000 \times 8\% \times 5$ years)	80,000
Repayment of principal at maturity (December 31, Year 9)	200,000
Total cash flows of new debt (undiscounted)	\$ 1,080,000

4. TDRs, debt modifications and extinguishments

Debtor discounts the cash flows using the effective interest rate of the original debt instrument, which was 10.68%. However, Debtor does not discount the \$800,000 cash outflow on January 1, Year 5 because it is paid on the modification date.

Present value of cash flows of new debt ¹	\$ 980,000
Present value of cash flows of original debt ²	(916,000)
Difference	\$ 64,000
	Change
Change in cash flows: $(\$980,000 - \$916,000) \div 916,000$	7%
Notes:	
1. Discounted at the 10.68% effective interest rate of the original debt.	
2. Calculated as \$1 million principal amount – \$84,000 unaccreted discount	

Because that change is less than 10%, Debtor concludes that the terms of the new debt instrument are not substantially different when applying the gross method. Therefore, Debtor applies modification accounting and records the cash outflow as a reduction of the debt as of January 1, Year 5 in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Loan payable	800,000	
Cash		800,000
<i>To recognize principal payment.¹</i>		
Note:		
1. Under the gross method, the unaccreted discount is not proportionately written off in relation to the partial payment; instead, the effective interest rate is increased so that the remaining balance of the discount is fully accreted over the remaining term of the debt.		

Debtor then determines the new effective interest rate based on the revised cash flows and the current carrying amount of the loan payable, which is \$116,000 (\$200,000 of remaining principal – \$84,000 of unaccreted discount). The revised cash flows of the modified arrangement require the following payments.

Interest payments $(\$200,000 \times 8\% \times 5 \text{ years})$	\$ 80,000
Repayment of principal at maturity (December 31, Year 9)	200,000

As a result, the new effective interest rate is approximately 23%. Therefore, if it uses the gross method, Debtor recognizes interest expense at 23% over the next five years related to the modified debt even though it makes interest payments based on the coupon interest of 8%.

Applying the net method

Under the net method, Debtor accounts for the \$800,000 cash outflow on January 1, Year 5 as a partial extinguishment of the original debt. The cash flow

4. TDRs, debt modifications and extinguishments

test is then performed using the cash flows related to the remaining \$200,000 of the original debt versus the cash flows related to the \$200,000 of the new debt.

First, Debtor determines the loss on extinguishment as follows.

Par value of debt	\$ 800,000
Unaccreted discount on debt (rounded) ¹	(67,000)
Net carrying amount of debt	733,000
Payment for partial extinguishment	(800,000)
Loss on debt extinguishment	\$ (67,000)
Note:	
1. Calculated as $(\$84,000 \text{ total unaccreted original debt discount} \times (\$800,000 \div (\$800,000 + \$200,000)))$.	

Debtor records the extinguishment of debt with an \$800,000 par value as of January 1, Year 5 in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Loan payable	800,000	
Loss on debt extinguishment	67,000	
Loan payable (discount on loan payable)		67,000
Cash		800,000
<i>To recognize principal payment and loss on debt extinguishment.</i>		

Next, Debtor performs the cash flow test using the cash flows related to the remaining \$200,000 of the original debt versus the \$200,000 of the new debt. Immediately after the above journal entry, the unaccreted original debt discount on the debt is \$17,000. Therefore, the remaining net carrying amount of the debt is \$183,000 (\$200,000 par value – \$17,000 unaccreted original debt discount).

Debtor is required to schedule all of the contractual cash flows under the new debt instrument. The cash flows are as follows.

Interest payments ($\$200,000 \times 8\% \times 5 \text{ years}$)	\$ 80,000
Repayment of principal at maturity (December 31, Year 9)	200,000
Total cash flows of new debt	\$ 280,000

Debtor is required to discount the cash flows using the effective interest rate of the original debt instrument, which is 10.68%.

Present value of cash flows of new debt ¹	\$ 180,000
Present value of cash flow of original debt ²	(183,000)
Difference	\$ 3,000

4. TDRs, debt modifications and extinguishments

	Change
Change in cash flows: $(\$183,000 - \$180,000) \div \$180,000$	1.6%
Notes:	
1. Discounted at the 10.68% effective interest rate of the original debt.	
2. Calculated as \$200,000 principal amount – \$17,000 unaccreted discount.	

Because that change is less than 10%, the terms of the new debt instrument are not substantially different than the old debt instrument when applying the net method.

Debtor then determines the new effective interest rate based on the revised cash flows and the current recorded balance of the loan payable. The current recorded balance of the loan payable is \$183,000 (\$200,000 of remaining principal – \$17,000 of unaccreted discount). The revised cash flows of the modified arrangement require the following payments.

Interest payments $(\$200,000 \times 8\% \times 5 \text{ years})$	\$ 80,000
Repayment of principal at maturity (December 31, Year 9)	200,000

As a result, the new effective interest rate is 10.3%. Therefore, if it uses the net method, Debtor records interest expense of \$97,000 over the next five years related to the modified debt even though it makes total interest payments of \$80,000 over that same time period.

Conclusion

The effective interest rate on the original debt instrument was 10.68%. If Debtor uses the gross method, the new effective interest rate for accounting purposes on the modified debt would be 23%. If it uses the net method, the new effective interest rate for accounting purposes on the modified debt would be 10.3%.

If Debtor believes the change in principal is significant and that the gross method results in an unusually high off-market effective interest rate for the modified debt, we believe it should consider whether the net method is more appropriate. However, use of the net method should be rare and applied only in limited and unusual circumstances in which the gross method produces a result that inappropriately ignores the economic substance of the transaction (see Question 4.4.120).

4.4.60 Applying cash flow test to debt denominated in foreign currency



Question 4.4.140

How is the cash flow test applied when the debt instruments are denominated in the same foreign currency?

Interpretive response: An issue arises when the debt instruments in a modification or exchange transaction are denominated in the same foreign currency before and after the modification or exchange (i.e. a currency other than the debtor's functional currency). In this instance, we believe the currency exchange rate in effect at the date of the modification or exchange should be used to determine the present value of the cash flows in the entity's functional currency used in the cash flow test.

Therefore, the fact that the debt instruments are denominated in a foreign currency does not affect the determination of whether the modification or exchange is substantial.



Question 4.4.150

How is the cash flow test applied when the original and new debt instruments are denominated in different currencies?

Interpretive response: Some modifications or exchanges of debt instruments may result in a new debt instrument that is denominated in a different currency than the original debt instrument. When evaluating whether a modification or exchange of debt instruments denominated in different currencies is substantial, we believe entities make one of the following accounting policy elections:

- to use the currency exchange rate in effect at the date of the modification or exchange
- to use an appropriate forward currency exchange rate to determine the cash flows in the cash flow test.

We believe it is also acceptable to make an accounting policy election that assumes any change in the currency in which the debt is denominated is always a substantial modification of the debt and therefore should be accounted for in the same manner as an extinguishment. The issuer should consistently apply the accounting policy it adopts.

4.4.70 Applying the cash flow test to noncash changes to a debt agreement

In many instances, a debtor may negotiate revised terms of its debt agreement with its lender that do not explicitly affect the cash flows of the revised debt agreement. For example, the revised debt agreement may require changes to the underlying collateral, changes to debt covenants, or a restricted cash account. In a restricted cash account, the debtor is required to deposit a specified amount of cash that is restricted from general use. The cash will be used for interest payments and to cure defaults on certain other covenants and could be returned to the debtor for certain reasons – e.g. to pay certain capital expenditures, operating expenses, etc.



Question 4.4.160

Do noncash changes to a debt agreement affect the cash flow test?

Interpretive response: No, unless they represent ‘amounts paid’. We believe noncash changes to a debt agreement should have no effect on a debtor’s calculation of the present value of the cash flows for purposes of applying the cash flow test. Paragraph 470-50-40-12(a) indicates that ‘any amounts paid’ to the creditor should be included in the cash flow test and is not explicit as to whether those amounts must be cash or noncash. We believe that ‘amounts paid’ include cash and other financial instruments (e.g. warrants, options, etc.) but do not include changes to collateral, covenant requirements and similar noncash changes.

Instead, we believe that any noncash modifications to the debt agreement (including changes in collateral, covenants and similar changes) are effectively contemplated by the creditor in establishing other terms of the new debt instrument. For example, increased collateral might result in a reduced interest rate on the modified debt as compared to the rate the lender would have accepted with less collateral. Therefore, collateral, covenants and similar changes are not included in the cash flow test because they are inherently captured in the effect that the other affected debt terms have on the cash flow test.

Note that considerations over noncash changes to a debt instrument (e.g. an increase in collateral requirements) conceptually differ when evaluating whether a modification or exchange is a TDR (see Question 4.2.120).

4.4.80 Debt instrument that is designated in a hedging relationship



Question 4.4.170

Does the modification of a debt instrument designated in a cash flow or fair value hedging relationship automatically terminate the existing hedging relationship?

Background: A hedging relationship may specifically identify:

- the contractually specified cash flows from the old debt instrument as the forecasted transaction in a cash flow hedging relationship; or
- the fair value of the old debt due to changes in a benchmark interest rate in a fair value hedging relationship.

Interpretive response: It depends on whether the modification is substantial.

Nonsubstantial modification

If the modification is not substantial, the debtor applies modification accounting to the old debt instrument, which continues to exist for accounting purposes – i.e. the modified debt instrument does not have a new accounting basis. Therefore, the hedging relationship does not need to be terminated, unless the hedging criteria in Topic 815 are no longer met. The hedging criteria would no longer be met, for example, if the hedging relationship is no longer highly effective as a result of the modification or the contractually specified cash flows have changed and affect the probability of the original forecasted transactions.

Substantial modification

If the modification is substantial, the debtor applies extinguishment accounting to the old debt instrument. The previous debt instrument ceases to exist for accounting purposes and a new debt instrument (the modified debt instrument) is recognized at its fair value. Because the old debt instrument is derecognized for accounting purposes, a hedging relationship needs to be terminated if it specifically identifies the derecognized old debt instrument as the hedged item in a fair value hedging relationship or the contractual cash flows in a cash flow hedging relationship.

The analysis differs for a cash flow hedging relationship in which cash flows from the old debt instrument are not specifically identified in the original hedge documentation. This occurs, for example, when a first payments method was being used to identify the forecasted interest payments. In this instance, cash flow hedge accounting does not need to be terminated regardless of whether the modification is substantial unless the hedging criteria in Topic 815 are no longer met. See section 6.10 of KPMG Handbook, [Derivatives and hedging](#).



Example 4.4.100

Modification of a debt instrument designated in a hedging relationship

Scenario 1: Fair value hedge – Debt modification not substantial

On January 1, Year 1, Debtor borrows \$10 million from Bank. The loan has a five-year term and bears interest at 8%, payable annually on December 31. Debtor can prepay the loan for its \$10 million par value at any time after December 31, Year 3.

On January 1, Year 1, Debtor also enters into a five-year interest rate swap based on the six-month term SOFR swap rate and designates it as the hedging instrument in a fair value hedge for changes in the fair value of the specific loan due to changes in the benchmark interest rate (i.e. six-month term SOFR).

On January 1, Year 5, Debtor and Bank modify the terms of the debt to increase the interest rate from 8% to 10% and extend the maturity date to December 31, Year 6. Debtor pays a modification fee of \$10,000 to Bank. On the modification date, Debtor performs the cash flow test and concludes that there has been no substantial modification – i.e. does not apply extinguishment accounting.

Because the debt modification is not substantial and therefore the debt is not considered extinguished, Debtor is not required to terminate its existing hedging relationship. However, given the changes to the debt instrument (interest rate and maturity date), Debtor needs to review the hedging criteria in Topic 815 to determine whether those criteria continue to be met.

Scenario 2: Cash flow hedge – Debt modification is substantial

On January 1, Year 1, Debtor borrows \$10 million from Bank. The loan has a five-year term and bears interest at six-month term SOFR) plus a spread of 2%, payable semi-annually on June 30 and December 31. Debtor may prepay the loan for its \$10 million par value at any time.

On January 1, Year 1, Debtor also enters into a five-year interest rate swap based on the six-month term SOFR swap rate and designates it as the hedging instrument in a cash flow hedge for changes in the contractually specified cash flows of the specific note due to changes in the six-month term SOFR rate.

On January 1, Year 5, Debtor and Bank modify the terms of the debt to increase the interest rate spread from 2% to 18% and extend the maturity date to December 31, Year 9. Debtor pays a modification fee of \$1 million to Bank. On the modification date, Debtor performs the cash flow test and concludes that there has been a substantial modification that requires it to apply extinguishment accounting.

Because the debt modification is substantial and the original debt is considered extinguished, Debtor is required to terminate its existing hedging relationship immediately and reclassify the related amounts in AOCI into the income statement. Because it is probable that the originally documented forecasted transaction will not occur, Debtor also needs to determine the effect of terminating the hedging relationship on its other existing hedging relationships.

4.4.90 Repayment of old debt with proceeds from issuance of new debt



Excerpt from ASC 470-50

> Modifications and Exchanges

40-8 Transactions involving the modification or exchange of debt instruments shall only result in gain or loss recognition by the debtor if the conditions for extinguishment of debt described in paragraph 405-20-40-1 are satisfied or if the guidance in this Subtopic requires that accounting.

40-9 Transactions involving contemporaneous exchanges of cash between the same debtor and creditor in connection with the issuance of a new debt obligation and satisfaction of an existing debt obligation by the debtor would only be accounted for as debt extinguishments if the debt instruments have substantially different terms, as defined in this Subtopic.

> Implementation Guidance

- > Identification of Debtor and Creditor

55-3 In a **public debt issuance**, for purposes of applying the guidance in this Subtopic, the debt instrument is the individual security held by an investor, and the creditor is the security holder. If an exchange or modification offer is made to all investors and only some agree to the exchange or modification, then the guidance in this Subtopic shall be applied to debt instruments held by those investors that agree to the exchange or modification. Debt instruments held by those investors that do not agree would not be affected.

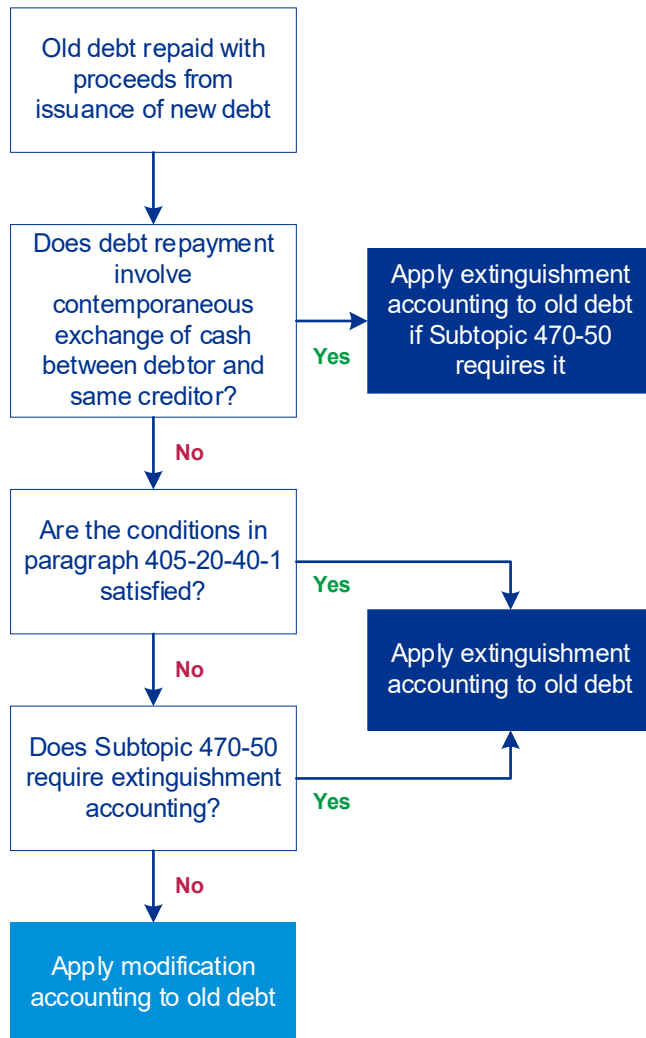
When an old debt is repaid with the proceeds from the issuance of new debt, extinguishment accounting is not automatically applied to the old debt. Subtopic 470-50 contains special provisions for these types of debt restructurings.



Question 4.4.180

How is a debt accounted for when it is repaid with proceeds from the issuance of new debt?

Interpretive response: The following decision tree summarizes how old debt is accounted for in this circumstance. The analysis potentially involves both paragraph 405-20-40-1 and the modifications and exchanges guidance in Subtopic 470-50 – but see Question 4.4.190 about when this Subtopic 470-50 guidance may not apply even though the repayment involves a contemporaneous exchange of cash between the debtor and the same creditor. [\[470-50-40-8 – 40-9\]](#)



Subtopic 470-50 requires extinguishment accounting if the old and new debt instruments have substantially different terms (see section 4.4.40).

As further explained in section 4.10, under paragraph 405-20-40-1, a liability is extinguished if either:

- the debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
 - delivery of cash
 - delivery of other financial assets
 - delivery of goods or services
 - reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds, or;
- the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For these purposes, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in

conjunction with the sale of an asset that serves as sole collateral for that debt.



Question 4.4.190

Is a debt restructuring subject to the guidance on modifications and exchanges when old debt is repaid with proceeds from issuance of new debt?

Background: This Question applies to the following fact pattern. Debtor restructures its debt and repays its old debt instrument with the proceeds of a new debt instrument whereby some lenders (i.e. creditors) that were part of the old debt instrument also participate as lenders in the new debt instrument.

Interpretive response: We understand there are two views in practice as to whether a debt restructuring in the Background section is subject to Subtopic 470-50's guidance on modifications and exchanges. These views differ because of different interpretations of the following paragraphs.

- Paragraph 470-50-40-8 provides guidance for transactions involving the modification or exchange of debt instruments and focuses on repayment of or legal release from the debt.
- Paragraph 470-50-40-9 provides guidance for transactions involving contemporaneous exchanges of cash between the same debtor and creditor in connection with the issuance of a new debt obligation and satisfaction of an existing debt obligation.

Subtopic 470-50 does not specify which guidance should be followed in the Background fact pattern. Given the diversity in practice, we believe both views are acceptable, and Debtor may make an accounting policy election and apply it consistently.

View A: Certain debt restructurings are not subject to Subtopic 470-50's guidance if certain conditions are met (based on paragraph 470-50-40-8)

Apply paragraph 405-20-40-1 to determine whether the debt has been extinguished. Only apply the guidance in Subtopic 470-50 if paragraph 405-20-40-1 does not require extinguishment accounting.

View B: All debt restructurings are subject to Subtopic 470-50's guidance (based on paragraph 470-50-40-9)

Apply the guidance in Subtopic 470-50 in every situation in which some lenders that were part of the old debt instrument also participate as lenders in the new debt instrument. Do not apply the guidance in paragraph 405-20-40-1 first.

View A: Certain debt restructurings are not subject to Subtopic 470-50's guidance

Under this view, even though there is a contemporaneous exchange of cash flows (inflow for the new debt instrument and outflow for the old debt instrument) between the same Debtor and Creditor, it is not considered to be an exchange of one debt instrument for another, but rather two independent, nonlinked transactions. Therefore, Debtor first determines whether the provisions of paragraph 405-20-40-1 have been met (on a lender-by-lender basis

4. TDRs, debt modifications and extinguishments

if multiple lenders are involved). If met, Debtor accounts for the old debt instrument as extinguished. If the provisions are not met, Debtor performs the cash flow test (under paragraphs 470-50-40-10 to 40-12) to determine whether the old debt instrument is deemed extinguished or merely modified (on a lender-by-lender basis).

We believe Debtor may treat the settlement of the old debt instrument as an extinguishment for accounting purposes (under paragraph 405-20-40-1), and not apply the substantially different test (discussed in section 4.4.40), if the following factors are present.

Factors	Additional considerations
<p>The old debt instrument has been:</p> <ul style="list-style-type: none"> — repaid in accordance with its original contractual terms; or — repurchased for its fair value. 	<p>The following may be relevant when analyzing this factor.</p> <p>Debt was repaid in accordance with its original contractual terms</p> <p>This may occur e.g. when Debtor redeems the old debt instrument through exercise of a contractual call option or prepayment option, with Debtor paying the original contractual call option price or prepayment option price to each and every old creditor.</p> <p>Example 1: if the old debt instrument was callable by Debtor at 101% of par, and Debtor called the instrument and each paid old debt instrument holder was offered 101% of par; or</p> <p>Example 2: if the old debt instrument was prepayable by Debtor at par, and Debtor prepaid the old debt instrument at par.</p> <p>If the old debt instrument is not prepayable or Debtor has not exercised a contractual call provision in the old debt instrument, a legal analysis may be necessary to determine whether the old debt instrument has been repaid in accordance with its original contractual terms.</p> <p>Debt was repurchased for its fair value</p> <p>This may occur e.g. if Debtor conducted a tender offer for its debt or repurchased its debt via a transaction in the secondary market.</p>
<p>The process management used to issue the new debt instrument indicates the placement of new debt.</p>	<p>The following may be relevant when analyzing this factor.</p> <ul style="list-style-type: none"> — Management (or its agent) set the terms of the new debt instrument to be commensurate with current market conditions (including considering Debtor’s current credit risk). — Management held a road show (or opened an e-room) so that potential investors could independently decide whether to invest in the new debt. — The new debt was over- or under-subscribed. — The old debt is Term A while the new debt is Term B.

4. TDRs, debt modifications and extinguishments

Factors	Additional considerations
<p>Management did not offer to exchange or modify the old debt instrument.</p>	<p>The following may be relevant when analyzing this factor.</p> <ul style="list-style-type: none"> — There were no conversations or discussions with old creditors about modifying the old debt. — The investment decision made by creditors in the new debt instrument is not linked to or conditioned on being an existing creditor. — All lenders in the new debt instrument were provided the same incentive (premium or discount to par) to participate in the new debt instrument (regardless of whether they were a creditor in the old debt instrument). — Lenders in the old debt were not required to invest in the new debt to be paid the amount due under the old debt agreement.
<p>The cash flows paid to contractually settle the old debt instrument and the cash flows received to issue the new debt instrument are distinguishable, even if a net amount is exchanged.</p>	<p>The following may be relevant when analyzing this factor.</p> <ul style="list-style-type: none"> — Debtor (or its agent) paid the old creditors the total amount due under the old debt instrument (including any prepayment penalty) regardless of whether they were also a creditor under the new debt instrument. — Debtor (or its agent) net cash-settled the difference with the old creditor but that net cash exchange is the difference between a gross amount payable to the old creditor (including any prepayment penalty) less the gross amount payable to Debtor for the old creditor's investment in the new debt instrument (including any premiums or discounts). Such net settlement is typically done to reduce credit risk for both the investor and the issuer. — Debtor (or its agents) received the total proceeds of the new debt instrument days or weeks before paying off the creditors of the old debt instrument (e.g. for accounting purposes, Debtor had both the old debt and the new debt recorded as liabilities for days or weeks).
<p>If Debtor used an agent, the contractual terms of any agreements with that agent are consistent with the issuance of a new debt instrument.</p>	<p>The following may be relevant when analyzing this factor.</p> <ul style="list-style-type: none"> — There is a written agreement between the agent and Debtor that specifies the relationship as that of an agent relationship in the capacity of replacing the old debt and issuing new debt. — The agent is paid its fee based on the total amount of the new debt instrument, at current market rates of compensation, and does not receive differing payments depending on the level of participation of the old lenders.

If all of the above five factors are present, the old debt instrument is considered extinguished for accounting purposes and all unaccrued fees associated with the old debt instrument are included in the gain or loss on extinguishment. Lender fees and all third-party costs (including agent fees) incurred in connection with the new debt instrument are deferred and accreted using the effective interest method.

If all of the above five factors are not present, then the cash flow test under paragraphs 470-50-40-10 to 40-12 is required for situations where the same creditor participated under both the old and new debt instruments.

View B: All debt restructurings are subject to Subtopic 470-50's guidance

View B is based on the analysis that paragraph 470-50-40-8 interprets the meaning of Subtopic 405-20-40-1 and therefore the cash flow test in paragraphs 470-50-40-10 to 40-12 is always performed when a creditor that was a party to the old debt instrument is also a party to the new debt instrument, regardless of the level of participation in either instrument.

4.5 Extinguishment accounting for non-TDR debt restructurings

4.5.10 Extinguishment accounting (general model)



Excerpt from ASC 470-50

> Extinguishments of Debt

40-1 As indicated in paragraph 470-50-15-4, the general guidance for the extinguishment of liabilities is contained in Subtopic 405-20 and defines transactions that the debtor shall recognize as an extinguishment of a liability.

40-2 A difference between the **reacquisition price of debt** and the **net carrying amount of the extinguished debt** shall be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. Gains and losses shall not be amortized to future periods. If upon extinguishment of debt the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges shall be given appropriate accounting recognition. Moreover, extinguishment transactions between related entities may be in essence capital transactions.

40-2A In an early extinguishment of debt for which the fair value option has been elected in accordance with Subtopic 815-15 on embedded derivatives or Subtopic 825-10 on financial instruments, the net carrying amount of the extinguished debt shall be equal to its fair value at the reacquisition date. In accordance with paragraph 825-10-45-6, upon extinguishment an entity shall include in net income the cumulative amount of the gain or loss previously recorded in other comprehensive income for the extinguished debt that resulted from changes in instrument-specific credit risk.

40-3 In an early extinguishment of debt through exchange for common or preferred stock, the reacquisition price of the extinguished debt shall be determined by the value of the common or preferred stock issued or the value of the debt—whichever is more clearly evident.

> Subsequent Accounting for Modifications and Exchanges If Extinguishment Accounting Is Applied

40-13 If it is determined that the original and new debt instruments are substantially different, the new debt instrument shall be initially recorded at fair value, and that amount shall be used to determine the debt extinguishment gain or loss to be recognized and the effective rate of the new instrument.



Question 4.5.10

How does a debtor account for a modification or exchange when extinguishment accounting applies?

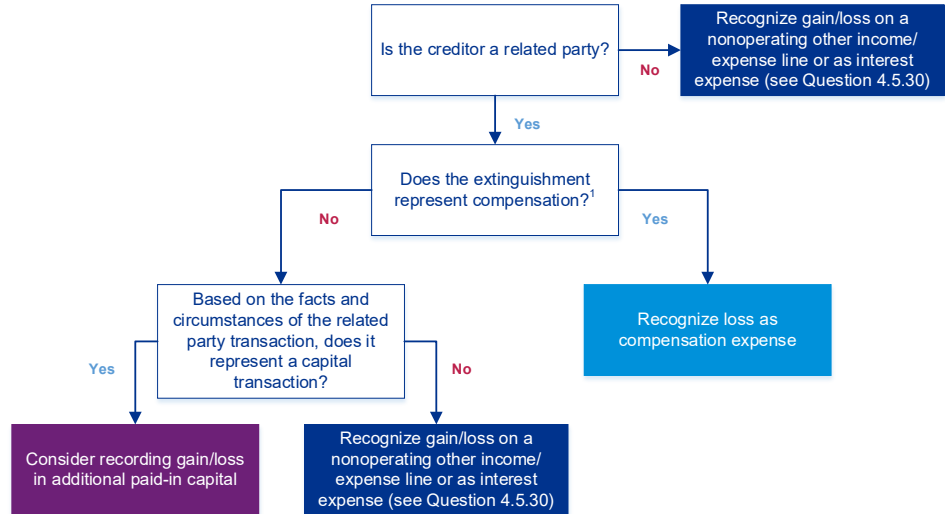
Interpretive response: When a nonconvertible debt instrument is modified or exchanged in a transaction and it is determined that the new instrument is substantially different, the original debt is considered extinguished and is accounted for as follows.

Carrying basis of the new debt instrument	The new debt is initially recorded at fair value. [470-50-40-13]
Gain or loss on debt extinguishment	A gain or loss on debt extinguishment is recognized as the difference between the fair value of the new debt and the net carrying amount of the old debt. The net carrying amount of the old debt includes any unaccreted/unamortized debt discounts/premiums and issuance costs. [470-50-40-2, 40-6]
Unamortized/unaccreted debt issuance costs and debt discount/premiums of the old debt	Unaccreted third-party debt issuance costs and unaccreted/unamortized debt discounts or premiums at the modification date that are included in the net carrying amount of the old debt are included in determining the debt extinguishment gain or loss. [470-50-40-2, 40-6]
Fees paid to the creditor relating to the modification or exchange	Fees between the creditor and debtor are considered to be associated with the old debt and are included in determining the debt extinguishment gain or loss. [470-50-40-17(a)]
Transaction costs paid to third parties directly relating to the exchange or modification	Third-party transaction costs are considered to be associated with the new debt and are deferred and accreted over the term of the new debt using the effective interest method. [470-50-40-18(a)]
New effective interest rate determined	The new rate is based on the cash flows of the new debt instrument and is used to accrete deferred issuance costs and/or discount of the new debt under the effective interest method. [470-50-40-13]

Question 4.5.20#
How does the debtor recognize and present the gain or loss on extinguishment?

Interpretive response: The gain or loss on a debt extinguishment is the difference between the amount paid to settle the debt (i.e. the reacquisition price) and the net carrying amount of the extinguished debt (see Question 4.5.110).

How an extinguishment gain or loss is recognized and presented (including whether it is presented in the income statement) depends on the nature of the consideration exchanged and the relationship between the debtor and the creditor. [470-50-40-1 – 40-2]



Note:
 1. An extinguishment could represent a compensatory transaction with a related party if the price paid to settle the debt is greater than the carrying amount.

Regardless of its classification, a significant gain or loss on the extinguishment of debt is disclosed in the notes to the financial statements.

Question 4.5.30#
When a debt extinguishment gain or loss is recognized in the income statement, can it be presented as interest expense?

Interpretive response: Yes, unless the extinguishment represents compensation. When the extinguishment represents compensation, the gain or loss is recognized as compensation expense. Otherwise, presentation of debt extinguishment gains and losses within a nonoperating other income and expense line item in the income statement generally is appropriate. However, we believe that presentation of debt extinguishment gains and losses within

the interest expense line item in the income statement may also be acceptable with appropriate disclosure in the notes to the financial statements.



Question 4.5.40#

Does extinguishment accounting for convertible instruments differ based on their nature and type?

Interpretive response: Yes. The accounting treatment for extinguishment of convertible instruments can differ based on the nature of the instrument (convertible debt or convertible preferred shares), and how the conversion option is accounted for, as follows:

- the convertible debt instrument has an equity component that was separately recorded because the instrument was issued at a substantial premium;
- the debt or equity instrument has a conversion feature that was initially bifurcated as a derivative and subsequently reclassified to equity; and
- the debt or equity instrument has a conversion feature that was not separately recognized.

See section 4.5.20 for applying extinguishment accounting in the aforementioned scenarios. See chapter 10 for accounting for settlement transactions that are accounted for as conversions or induced conversions.



Example 4.5.10

Applying extinguishment accounting in a substantial modification

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and bears interest at 8%, payable annually on December 31.
- There are no prepayment features.
- Debtor pays a \$30,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$20,000 of debt issuance costs with third parties.

On January 1, Year 5, Debtor and Bank modify the terms of the debt as follows.

- Debtor pays a \$10,000 modification fee to Bank.
- The interest rate is increased from 8% to 12%.
- The maturity date is extended four years, to December 31, Year 9.

Debtor incurs \$13,000 of third-party costs in connection with the modification. It determines that this modification does not represent a TDR. The fair value of the new debt instrument on the modification date is \$1,035,000.

4. TDRs, debt modifications and extinguishments

Immediately before the modification, the following amounts are relevant.

Par value of debt	\$ 1,000,000
Unaccreted discount on the loan	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	\$ 991,000

Debtor performs an analysis of the modification and determines that the new debt instrument is substantially different than the original debt, and therefore it applies extinguishment accounting.

Accounting for the extinguishment

Debtor records the debt extinguishment as of January 1, Year 5 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Loan payable (old debt)	1,000,000	
Loss on debt extinguishment ¹	54,000	
Loan payable (discount – old debt) ²		5,000
Loan payable (debt issuance costs – old debt) ²		4,000
Loan payable (new debt) ³		1,000,000
Loan payable (premium on loan payable – new debt) ³		35,000
Cash ⁴		10,000
<i>To recognize debt extinguishment and related loss on extinguishment.</i>		
Loan payable (debt issuance costs – new debt) ⁵	13,000	
Cash ⁵		13,000
<i>To recognize debt issuance costs on new debt.</i>		
Notes:		
1. The \$54,000 excess of (a) the \$1,045,000 sum of (1) the fair value of the new debt instrument (\$1,035,000) plus (2) the modification fee (\$10,000) over (b) the \$991,000 net carrying amount of the original debt instrument (\$1 million par value – \$5,000 unaccreted debt discount – \$4,000 unamortized debt issuance costs) is recorded as a loss on debt extinguishment.		
2. Debtor writes off the \$4,000 of unaccreted third-party debt issuance costs and \$5,000 of unaccreted debt discount at the modification date and includes this total in determining the debt extinguishment gain or loss.		
3. Debtor records the new debt at its \$1,035,000 fair value on the modification date.		
4. The \$10,000 modification fee paid to Bank is included in determining the debt extinguishment gain or loss because the modification is substantial.		
5. The \$13,000 of third-party costs related to the modification are deferred and accreted over the term of the new debt instrument in a manner similar to debt issuance costs because the modification is substantial.		



Example 4.5.20

Extinguishment accounting – new debt instrument has a below market interest rate

On January 1, Year 1, Debtor issues at par a five-year, \$10 million note bearing interest at 7% to Creditor. There are no prepayment features and the debt issuance costs were insignificant.

On January 1, Year 5, Debtor exchanges the note for a new \$10 million note with a maturity date extended to December 31, Year 9. The new note bears interest at 11%. However, Debtor's market interest rate at the date of the exchange exceeds 11%, so the fair value of the new debt instrument on that date is less than its par value. Transaction costs related to the exchange were insignificant and the exchange is not a TDR.

After applying the cash flow test, Debtor deems the modification to be substantial, and considers the original debt extinguished. Debtor determines the fair value of the new debt is \$9.2 million, and computes an extinguishment gain as follows.

Net carrying amount of old debt (par value)	\$ 10,000,000
Fair value of new debt	(9,200,000)
Gain on extinguishment	<u>\$ 800,000</u>

Debtor records a discount on the new debt equal to the difference between its fair value and its par value. Debtor then accretes the discount using the effective interest method, which will result in subsequent recognition of interest expense at the market rate on the exchange date.

Debtor records these items as of January 1, Year 5 in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Note payable (old debt)	10,000,000	
Loan payable (discount on loan payable – new debt) ¹	800,000	
Note payable (new debt)		10,000,000
Gain on extinguishment ¹		800,000
<i>To recognize debt exchanged and related gain on debt extinguishment.</i>		

Note:

- Debtor records an extinguishment gain and debt discount of \$800,000, which represents the difference between the net carrying amount of the original debt, \$10 million and the fair value of the new debt, \$9.2 million.

**Example 4.5.60****Partial forgiveness of debt by a parent – capital transaction**

On January 1, Year 4, Subsidiary, which is majority owned by Parent, issues a two-year note for its par value of \$1 million to Parent.

In July, Year 5, Parent contacts Subsidiary to accelerate payment of the note. Parent is experiencing cash flow problems and is willing to accept less than the par value of the note if Subsidiary repays the note immediately. Subsidiary and Parent agree to settle the note immediately for \$700,000. At the settlement date, the carrying amount of the note is as follows.

Par value of debt	\$ 1,000,000
Unaccreted debt issuance costs	(50,000)
Net carrying amount of debt	\$ 950,000

Because the counterparty is its controlling shareholder, Subsidiary concludes that the extinguishment embodies a capital transaction. Therefore, it records the \$250,000 difference between the \$950,000 net carrying amount of the debt and the \$700,000 settlement amount as a capital contribution (i.e. an increase to APIC) in the following journal entry as of the settlement date.

	<i>Debit</i>	<i>Credit</i>
Debt ¹	1,000,000	
Cash ²		700,000
Debt (debt issuance cost) ¹		50,000
APIC ²		250,000
<i>To recognize principal payment and related effect on APIC (as it represents a capital transaction).</i>		

Notes:

1. To record the extinguishment of the debt (principal of \$1 million) and write off the remaining unaccreted debt issuance costs (\$50,000).
2. To record the cash repayment of \$700,000, with the difference (\$250,000) between the principal value and settlement amount as a capital contribution (to APIC).

**Example 4.5.70****Share settlement of debt in a related-party transaction**

ABC Corp., a closely held company, has two shareholders with significant equity interests who have each made \$500,000 loans to ABC (i.e. \$1 million in total).

4. TDRs, debt modifications and extinguishments

ABC is changing its capital structure and plans to issue common shares to the two significant shareholders to extinguish the debt. On the date of the exchange, the net carrying amount of the debt is as follows.

Par value of debt	\$ 1,000,000
Unaccreted discount on debt	(100,000)
Unaccreted debt issuance costs	(50,000)
Net carrying amount of debt	\$ 850,000

The fair value of the shares issued in exchange for the debt is \$1.1 million, which is more clearly evident than the fair value of the debt.

ABC does not recognize a loss on extinguishment of the debt in this example because the exchange is considered a capital transaction with significant shareholders. Because the \$250,000 difference between the \$850,000 net carrying amount of the debt and the \$1.1 million fair value of the shares arose in connection with a capital transaction between ABC and related parties (significant shareholders), ABC records the \$250,000 difference as a reduction of APIC.

As a result, ABC effectively records the common shares issued in connection with the exchange transaction at the \$850,000 net carrying amount of the debt in the following journal entry as of the exchange date.

	<i>Debit</i>	<i>Credit</i>
Debt with related parties ¹	1,000,000	
APIC ²	250,000	
Debt (debt issuance costs) ¹		50,000
Debt (discount) ¹		100,000
Common shares/APIC ³		1,100,000
<i>To recognize debt extinguishment and issuance of common shares.</i>		
Notes:		
1. To record the extinguishment of the debt (principal of \$1 million) and write off the remaining unaccreted debt discount (\$100,000) and unaccreted debt issuance costs (\$50,000).		
2. To record the reduction to APIC for the excess value of the common shares issued (\$1.1 million) over the carrying amount of the debt (\$850,000).		
3. To record the issuance of common shares.		

**Example 4.5.80****Share settlement of a note payable – not a related party transaction**

On January 1, Year 4, Debtor borrows \$1 million from Bank.

- The loan has a 10-year term and bears interest at 8%, payable annually on December 31.
- Debtor may prepay the note for its principal amount plus 1% (i.e. issuer call option) at any time after three years. The call option does not require bifurcation as a derivative under Topic 815.
- Debtor pays a \$50,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$30,000 of debt issuance costs to third parties.
- The terms of the debt do not include an equity conversion option – i.e. the instrument is a nonconvertible debt.

Debtor records the borrowing and related debt issuance costs as of January 1, Year 4 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash ¹	950,000	
Loan payable (discount on loan payable) ¹	50,000	
Loan payable ¹		1,000,000
<i>To recognize debt and discount on debt.</i>		
Loan payable (debt issuance costs) ²	30,000	
Cash ²		30,000
<i>To recognize debt issuance costs.</i>		
Notes:		
1. To record the loan payable of \$1 million, the net cash received (\$1,000,000 less the \$50,000 lender fee paid), and the \$50,000 difference between the loan payable and cash received, which is recorded as a debt discount.		
2. To record the \$30,000 cash paid for debt issuance costs.		

Accretion of debt discount and debt issuance costs

Debtor accretes the \$50,000 debt discount and the \$30,000 of debt issuance costs using the effective interest method over the 10-year term of the borrowing. From January 1, Year 4 to December 31, Year 8, Debtor accretes approximately \$29,000 of the debt discount and \$17,000 of the debt issuance costs into interest expense.

On January 1, Year 9, the contractual prepayment amount is \$1.01 million (\$1 million principal amount plus 1% prepayment premium). However, Debtor negotiates an agreement with Bank that permits it to settle the loan on that date in exchange for the issuance of common shares with a fair value of \$1.05 million. Transaction costs associated with the exchange are insignificant and the

4. TDRs, debt modifications and extinguishments

fair value of the common shares is more clearly evident than the fair value of the loan payable.

At the settlement date, Debtor determines the debt's net carrying amount and the loss on extinguishment as follows.

Par value of debt	\$ 1,000,000
Unaccreted discount on the loan	(21,000)
Unaccreted third-party debt issuance costs	(13,000)
Net carrying amount of debt	966,000
Settlement amount	(1,050,000)
Loss on debt extinguishment	\$ (84,000)

Debtor records the extinguishment of the loan as of January 1, Year 9 in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Loan payable ¹	1,000,000	
Loss on debt extinguishment ²	84,000	
Loan payable (discount on loan payable) ³		21,000
Loan payable (debt issuance costs) ³		13,000
Common shares/APIC ⁴		1,050,000
<i>To recognize debt extinguishment and issuance of common shares.</i>		

Notes:

1. The principal balance remaining on the loan at December 31, Year 8.
2. The loss on extinguishment (difference between the net carrying amount of the loan of \$966,000 and the fair value of the shares issued of \$1.05 million).
3. The unaccreted discount and deferred financing cost balance at December 31, Year 8.
4. To record the issuance of common shares.

In contrast to Example 4.5.70, share settlement of debt results in an extinguishment loss being reported in earnings in this example because, unlike Example 4.5.70, the creditors are unrelated parties.

4.5.20 Extinguishment accounting for convertible debt



Question 4.5.50#

How does a debtor apply extinguishment accounting when convertible debt is modified or exchanged?

Interpretive response: If a modification or exchange of a convertible debt instrument results in application of extinguishment accounting (after evaluating the substantially different tests outlined in section 4.4.40), the debtor applies extinguishment accounting as discussed in this section.

The debtor recognizes the new/modified debt instrument at its fair value as of the date of the modification/exchange. It also evaluates the new instrument for proper recognition of any conversion or other embedded features; see chapter 10. Any fees paid to/received from the creditor are included in the debt extinguishment gain or loss, and any third-party costs directly related to the modification or exchange are treated as debt issuance costs of the newly recognized instrument (see section 4.5.30).

We believe the debtor considers the terms/features of the original debt instrument when determining the calculation of the gain/loss on extinguishment, as explained in the following table.

The original debt instrument	Calculating the gain/loss on extinguishment
Traditional convertible debt (i.e. no accounting recognition for the conversion feature)	In determining the extinguishment accounting of the original instrument, the debtor recognizes an extinguishment gain or loss equal to the difference between the total consideration transferred in the modification/exchange (which includes the fair value of the new instrument and any amounts paid to/received from the holder) and the previous net carrying amount of the original debt instrument as of the date of the modification/exchange.
Convertible debt with bifurcated conversion options or other bifurcated features	If conversion option or other features of the original debt instrument were bifurcated and separately accounted for as a derivative upon issuance, the fair value of the bifurcated option/feature at the date of the modification/exchange is included in the carrying amount of the original debt instrument when comparing to the fair value of the modified debt to calculate the gain/loss on extinguishment.
Convertible debt issued at a substantial premium	See Question 4.10.80 for further detail.



Example 4.5.90

Convertible note payable exchanged for convertible preferred shares

On January 1, Year 4, Debtor issues a convertible note payable for its par value of \$1 million.

- The convertible note has a seven-year term, bears interest at 8%, payable annually on December 31.
- The note is convertible into 50,000 of Debtor's common shares (i.e. a \$20 per share conversion price).
- The convertible note is in the scope of the 'no proceeds allocated' model. The conversion feature does not require bifurcation as a derivative and each note was issued for its par value (and therefore not at a substantial premium).
- Debtor incurs \$50,000 of debt issuance costs with third parties.

Debtor records the issuance of the convertible debt in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	1,000,000	
Convertible note payable		1,000,000
<i>To recognize issuance of convertible note.</i>		
Convertible note payable (debt issuance costs)	50,000	
Cash		50,000
<i>To recognize debt issuance costs.</i>		

Accretion of debt issuance costs

Debtor accretes the \$50,000 of debt issuance costs using the effective interest method over the seven-year term of the note. From January 1, Year 4 to December 31, Year 8, Debtor accretes \$33,000 of the debt issuance costs into interest expense.

On January 1, Year 9, Debtor enters into an exchange transaction with the creditor such that the convertible note payable on that date is exchanged for convertible preferred shares with a fair value of \$980,000. Transaction costs associated with the exchange are insignificant. On that date, the note's net carrying amount is as follows.

Par value of note	\$ 1,000,000
Unaccreted debt issuance costs	(17,000)
Net carrying amount of note	\$ 983,000

The exchange of a convertible debt instrument for convertible preferred shares (a) does not represent the exercise of a conversion option provided in the terms

of the debt and (b) does not represent an induced conversion, so Debtor accounts for it as an extinguishment.

Because the fair value of the convertible preferred shares is less than the net carrying amount of the debt, Debtor records a gain of \$3,000 (\$980,000 fair value of preferred shares less \$983,000 net carrying amount of debt).

Debtor records the exchange in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Convertible note payable	1,000,000	
Gain on debt extinguishment		3,000
Convertible note payable (debt issuance costs)		17,000
Convertible preferred shares		980,000
<i>To recognize exchange of convertible notes for convertible preferred shares.</i>		

While Debtor initially recognizes the convertible preferred shares at fair value, it needs to analyze the convertible preferred shares for any further accounting implications for conversion options (e.g. embedded derivative requiring separation), other embedded features requiring separation, and appropriate classification of the preferred shares (temporary equity or permanent equity).

4.5.30 Accounting for fees and issuance costs when extinguishment accounting is applied



Excerpt from ASC 470-50

> Fees between Debtor and Creditor

40-17 Fees paid by the debtor to the creditor or received by the debtor from the creditor (fees may be received by the debtor from the creditor to cancel a call option held by the debtor or to extend a no-call period) as part of the exchange or modification shall be accounted for as follows:

- a. If the exchange or modification is to be accounted for in the same manner as a debt extinguishment and the new debt instrument is initially recorded at fair value, then the fees paid or received shall be associated with the extinguishment of the old debt instrument and included in determining the debt extinguishment gain or loss to be recognized.

40-17A An increase or a decrease in the fair value of a freestanding equity-classified written call option held by a creditor (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a debt instrument held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)) shall be accounted for in the same manner as fees between the debtor and the creditor as described in paragraph 470-50-40-17.

> Third-Party Costs of Exchange or Modification

40-18 Costs incurred with third parties directly related to the exchange or modification (such as legal fees) shall be accounted for as follows:

- a. If the exchange or modification is to be accounted for in the same manner as a debt extinguishment and the new debt instrument is initially recorded at fair value, then the costs shall be associated with the new debt instrument and amortized over the term of the new debt instrument using the interest method in a manner similar to debt issue costs.

40-18A An increase (but not a decrease) in the fair value of a freestanding equity-classified written call option held by a third party (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a debt instrument (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)) shall be accounted for in the same manner as third-party costs incurred that are directly related to the modification or exchange of a debt instrument as described in paragraph 470-50-40-18.



Question 4.5.70

How does a debtor account for fees related to a debt modification when extinguishment accounting is applied?

Interpretive response: The following table summarizes how the debtor accounts for such fees as well as any unaccreted discounts, premiums and debt issuance costs. [470-50-40-17 – 40-18]

Fees and costs	Substantial modification (extinguishment accounting)
Unaccreted/unamortized discounts, premiums and debt issuance costs	Include in gain or loss on extinguishment of original debt
Fees paid to or received from creditors	Include in gain or loss on extinguishment of original debt
Fees paid to third parties	Capitalize and accrete as part of net carrying amount of the new debt using the effective interest method

See also Question 4.5.75 when a freestanding equity-classified written call option modification or exchange is a part of or directly related to a modification or an exchange of the existing debt instrument.



Question 4.5.75

How does a debtor account for a modification or exchange of a freestanding equity-classified written call option associated with a debt modification under extinguishment accounting?

Interpretive response: If a modification of a freestanding equity-classified written call option is in the scope of paragraphs 815-40-35-14 to 35-17 (see section 8.13.40), how the debtor recognizes and measures the modification's effect depends on whether the written call option is held by the creditor or a third party.

The following table summarizes how the debtor measures and recognizes that effect. [470-50-40-17 – 40-17A, 40-18 – 40-18A]

Holder of written call option	Accounting treatment
Creditor	The changes in the written call option's fair value (increases and decreases) are included in the gain or loss on extinguishment of the original debt – i.e. treated as fees paid to or received from the creditor; see Question 4.5.70. [470-50-40-17A]
Third party	Any increases (but not decreases) in the written call option's fair value are capitalized and accreted as part of the net carrying amount of the new debt using the effective interest method – i.e. treated as fees paid to third parties; see Question 4.5.70. [470-50-40-18A]

4.5.40 Fees and costs paid in anticipation of a debt amendment or restructuring

In anticipation of, and prior to entering into a future debt amendment or restructuring transaction, a debtor may pay fees specific to that future debt amendment or restructuring transaction to:

- an investment bank or other advisor to provide advisory services related to the specific debt amendment or restructuring including financial analysis, model development, preparation of transaction terms, financial advice, identification and facilitation of negotiations with creditors, and due diligence/coordination; and/or
- an attorney (legal counsel) on behalf of the creditors during the negotiation process for the specific debt amendment or restructuring.



Question 4.5.80

How are fees and costs accounted for if the related specific debt amendment or restructuring does not occur by the end of the reporting period?

Interpretive response: The debtor determines whether a debt amendment or restructuring is a substantial modification or an extinguishment in the reporting period in which it is completed. If fees are incurred in the current reporting period for such a specific transaction but the specific transaction is not completed by the end of the period, we believe the fees should be accounted for as follows in the current reporting period.

Investment bank/advisor (not a creditor) fees

The investment bank/advisor (who is not a creditor) may provide services that are directly related to a specific debt issuance or amendment during the service period. For example, the investment bank/advisor may be actively pursuing the issuance or amendment of specific debt on behalf of the debtor and the terms of the issuance or amendment are complete or almost complete, with active discussions with third parties. In these instances, we believe it is appropriate to defer the fees until the debt issuance or amendment has occurred and the debtor can assess whether the transaction is a modification or an extinguishment (see section 4.4). At such time the debtor would capitalize and accrete such third-party fees as part of net carrying amount of the new debt using the effective interest method (if an extinguishment) or expense them as incurred (if not an extinguishment).

In certain cases, the investment bank/advisor is providing typical treasury function activities that are not directly related to a specific debt issuance or amendment during the service period. As a result, unless the fees can be directly associated with a specific debt issuance or amendment (as illustrated in the above paragraph), we believe these fees should be expensed as incurred because they are not direct costs of issuing or amending a specific debt instrument. In some cases, investment banks or advisors may allow the payment of these fees (or a portion thereof) to be a credit toward and reduction of future success fees directly related to an executed debt amendment. We believe it is appropriate to record the portion of those fees that can be used as a credit to future success fees as a prepaid expense until the time the fees are credited against actual success fees, provided the debtor believes a future debt issuance or amendment is probable of occurring during the investment bank/advisor service period such that the credit may be used. When a debt issuance or amendment occurs and the prepaid fees are credited against success fees, the accounting for such fees will follow paragraph 470-50-40-18 because they are paid to a third party instead of to the creditor. Their accounting treatment under this paragraph will depend on whether the transaction is a substantial modification (extinguishment) or not (modification).

<p>Creditor legal fees</p>	<p>Fees paid to attorneys and legal counsel on behalf of creditors should be treated as if they were fees paid to the creditors themselves. Therefore, such fees are included in determining a debt extinguishment gain or loss if recognized or as part of the carrying amount of the new debt if extinguishment accounting is not applied. However, if the debt issuance or amendment has not occurred before the end of the reporting period, we believe it is appropriate to defer the fees until the debt issuance or amendment has occurred and the debtor can assess whether the transaction is a substantial modification or an extinguishment (see section 4.4).</p> <p>We believe deferral is appropriate based on the interplay between paragraphs 470-50-40-17 and 40-18. Paragraph 470-50-40-18 explicitly applies to the debtor's costs that are 'directly related to the exchange or modification,' but paragraph 470-50-40-17 does not include similar wording. This lack of consistent wording suggests there is a different threshold in the accounting for fees paid to third parties and fees paid to a creditor, given a debtor would only pay fees on behalf of a creditor outside the existing arrangement if the debtor were negotiating an exchange, waiver or amendment and perceived a future benefit specific to that creditor. Because paragraph 470-50-40-17 (both (a) and (b)), require the fees/costs to be accounted for at the time of the related amendment, we believe the fees paid to the creditor's legal counsel should be deferred until the time of the actual amendment if it is probable the amendment will occur.</p> <p>We believe deferral is appropriate because should the debt modification ultimately be substantial, the debtor would have to include those fees in its determination of the gain or loss on the extinguishment. Further, should the modification not be substantial, the debtor would have to accrete those fees over the modified debt's remaining term.</p>
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4.6 Modification accounting for non-TDR debt restructurings

4.6.10 Modification accounting (general model)



Excerpt from ASC 470-50

> Subsequent Accounting for Modifications and Exchanges If Extinguishment Accounting Is Not Applied

40-14 If it is determined that the original and new debt instruments are not substantially different, then a new effective interest rate shall be determined

based on the carrying amount of the original debt instrument, adjusted for an increase (but not a decrease) in the fair value of an embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) resulting from the modification, and the revised cash flows.



Question 4.6.10

What is the accounting treatment for a modification of nonconvertible debt?

Interpretive response: When a nonconvertible debt instrument is modified or exchanged in a transaction that is not accounted for as an extinguishment, the original debt is considered modified, and the restructuring transaction is accounted for as follows.

New effective interest rate determined	New rate is based on the original debt's net carrying amount and the revised cash flows. [470-50-40-14]
Fees paid to or received from creditor	Such fees are deferred by recording them as a decrease or increase in the debt's net carrying amount. They are subsequently recognized in interest expense using the new effective interest rate. [470-50-40-17(b)]
Transaction costs paid to third parties	Such costs are expensed as incurred. [470-50-40-18(b)]
Unaccreted fees/issuance costs on the original debt	Such fees and costs are accreted as an adjustment of interest expense over the remaining term of the modified debt instrument using the new effective interest rate. [470-50-40-17(b)]



Example 4.6.10

Applying modification accounting when a modification is not substantial

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and bears interest at 8%, payable annually on December 31.
- There are no prepayment features.
- Debtor pays a \$30,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$20,000 of debt issuance costs with third parties.
- The effective interest rate is 8.77% (rounded).

4. TDRs, debt modifications and extinguishments

Debtor has an accounting policy election to exclude debt issuance costs (1) when calculating the effective interest rate of the debt and (2) from the carrying amount of the debt when performing the cash flow test under paragraph 470-50-40-10.

On January 1, Year 5, Debtor and Bank modify the terms of the debt as follows.

- Debtor pays a \$10,000 modification fee to Bank.
- The interest rate is increased from 8% to 10%.
- The maturity date is extended by two years, to December 31, Year 7.

Debtor incurs \$13,000 of third-party costs in connection with the modification. Debtor determines that this modification is not a TDR.

Immediately before the modification, the net carrying amount of the loan is as follows.

Par value of loan	\$1,000,000
Unaccreted discount on the loan	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	\$ 991,000

Debtor analyzes the modification and determines that the new debt instrument is not substantially different than the original debt and therefore needs to apply modification accounting.

Accounting for the modification

The \$10,000 modification fee paid to Bank is deferred (i.e. recorded as a decrease to the net carrying amount of the debt instrument) and subsequently recognized as an adjustment of interest expense on the debt instrument using the effective interest method, because the modification is not substantial. However, the \$13,000 of third-party costs related to the modification are expensed as incurred because the modification is not substantial.

Debtor records the debt modification and related third-party costs as of January 1, Year 5 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Loan payable (discount on loan payable) ¹	10,000	
Cash		10,000
<i>To recognize debt modification fees.</i>		
Debt modification expense ²	13,000	
Cash		13,000
<i>To recognize third-party debt issuance costs.</i>		
Notes:		
1. To record the modification fee (recorded as a decrease to the carrying amount of the new debt).		
2. To record the third-party costs as an expense as the modification is not substantial.		

Effective interest rate subsequent to the modification

The \$10,000 modification fee paid to Bank is reflected in determining the effective interest rate on the debt instrument because the modification is not substantial. Debtor determines that the effective interest rate for the new debt instrument is 10.77% based on (a) the \$991,000 net carrying amount of the original debt instrument less the \$10,000 modification fee and (b) the revised cash flows of the new debt instrument.



Example 4.6.20

Applying modification accounting (with incremental borrowing) when a modification is not substantial

On January 1, Year 1, Debtor borrows \$1 million from Bank.

- The loan has a five-year term and bears interest at 8%, payable annually on December 31.
- There are no prepayment features.
- Debtor pays a \$30,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$20,000 of debt issuance costs with third parties.
- The effective interest rate is 8.77% (rounded).

Debtor has an accounting policy election to exclude debt issuance costs (1) when calculating the effective interest rate of the debt and (2) from the carrying amount of the debt when performing the cash flow test under paragraph 470-50-40-10.

On January 1, Year 5, Debtor and Bank modify the terms of the debt as follows.

- The principal amount is increased from \$1 million to \$1.3 million and Debtor pays a \$10,000 modification fee to Bank.
- The interest rate is increased from 8% to 9%.
- The maturity date is extended by four years, to December 31, Year 9.

Debtor incurs \$13,000 of third-party costs in connection with the modification. Debtor determines that this modification is not a TDR.

Immediately before the modification, the net carrying amount of the loan is as follows.

Par value of debt	\$1,000,000
Unaccreted discount on the loan	(5,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	\$ 991,000

Debtor analyzes the modification and determines that the new debt instrument is not substantially different than the original debt and therefore modification accounting applies.

Accounting for the modification

Debtor determines a new effective interest rate based on the revised cash flows. The \$10,000 modification fee paid to Bank is reflected in determining the effective interest rate on the debt instrument because the modification is not substantial. Debtor continues to accrete the \$5,000 of unaccreted original debt discount and the \$4,000 of unaccreted original third-party debt issuance costs at the modification date using the effective interest method over the remaining term of the new debt instrument. However, the \$13,000 of new third-party debt issuance costs related to the modification are expensed as incurred because the modification is not substantial. Debtor records the debt modification and related third-party costs as of January 1, Year 5 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	290,000	
Loan payable (discount on loan payable)	10,000	
Loan payable		300,000
<i>To recognize debt modification cash flows and fees paid to creditor.</i>		
Debt modification expense	13,000	
Cash		13,000
<i>To recognize third-party debt issuance costs.</i>		

4.6.20 Modification accounting for convertible debt



Excerpt from ASC 470-50

> Subsequent Accounting for Modifications and Exchanges If Extinguishment Accounting Is Not Applied

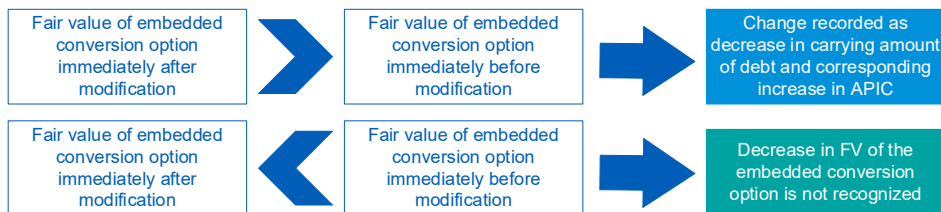
40-15 If a convertible debt instrument is modified or exchanged in a transaction that is not accounted for as an extinguishment, an increase in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) shall reduce the carrying amount of the debt instrument (increasing a debt discount or reducing a debt premium) with a corresponding increase in additional paid-in capital. However, a decrease in the fair value of an embedded conversion option resulting from a modification or an exchange shall not be recognized.



Question 4.6.20

What is the accounting treatment for a modification of convertible debt?

Interpretive response: When a convertible debt instrument, for which the conversion option is not bifurcated and accounted for separately as a derivative, is modified or exchanged in a transaction that is not accounted for as an extinguishment, the accounting depends on whether there is an increase or decrease in the fair value of the embedded conversion option – calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange. An increase in fair value is recorded as a decrease to the carrying amount of the debt instrument (increasing a debt discount or reducing a debt premium) with a corresponding increase to APIC.



In either of the above cases, a new effective interest rate is determined for the convertible debt instrument based on:

- the net carrying amount of the original convertible debt instrument, as adjusted for an increase (but not a decrease) in the fair value of the embedded conversion option resulting from the modification, and
- the revised cash flows of the new convertible debt instrument.

When the debt restructuring is not accounted for as an extinguishment, fees paid to or received from the creditor are deferred (i.e. recorded as a decrease or increase to the net carrying amount of the new convertible debt instrument). They are subsequently recognized as an adjustment of interest expense on the new convertible debt instrument using the effective interest method. However, third-party transaction costs are expensed as incurred in that circumstance. [470-50-40-17(b), 40-18(b)]



Example 4.6.30

Modification of a convertible debt instrument when extinguishment accounting is not applied

On January 1, Year 1, Debtor issues a \$1 million convertible note to Investor for its par value.

- The note has a five-year term and bears interest at 2%, payable annually on December 31.
- The note is convertible into 244,000 Debtor common shares (i.e. \$4.10 stated conversion price (rounded)).
- There are no prepayment features.

4. TDRs, debt modifications and extinguishments

- Debtor pays a \$30,000 fee to Investor at issuance, which it accounts for as a debt discount, and incurs \$20,000 of debt issuance costs to third parties.

The convertible note is in the scope of the 'no proceeds allocated' model. The conversion option is not required to be bifurcated and accounted for as a derivative and it was issued for its par value (and therefore not at a substantial premium).

Debtor records the convertible debt issuance and related debt issuance costs in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	970,000	
Convertible note (discount on convertible note)	30,000	
Convertible note (debt issuance costs)	20,000	
Convertible note		1,000,000
Cash		20,000
<i>To recognize issuance of a convertible note and related issuance costs.</i>		

Debtor accretes the \$30,000 debt discount and the \$20,000 of debt issuance costs using the effective interest method over the five-year term of the borrowing. From January 1, Year 1 to December 31, Year 4, Debtor accretes approximately \$24,000 of the debt discount and \$16,000 of the debt issuance costs into interest expense.

On January 1, Year 5, when Debtor's share price is \$3 per share, Debtor and Investor modify the terms of the debt as follows.

- Debtor pays a \$10,000 modification fee to Investor.
- The interest rate is increased from 2% to 4%.
- The maturity date is extended by two years, to December 31, Year 7.
- The number of shares issuable on conversion is increased from 244,000 shares to 250,000 shares (i.e. a decrease in the stated conversion price from \$4.10 per share to \$4.00 per share).

Debtor incurs \$13,000 of third-party costs in connection with the modification. Debtor determines that this modification is not a TDR. It determines that the fair value of the embedded conversion feature in the old debt at the date of modification is \$25,000 and the fair value of the embedded conversion feature in the new debt at the date of modification is \$105,000. The \$80,000 increase in the fair value at the date of modification was due to the reduction in the conversion price and the extension of the convertible note's remaining term.

Immediately before the modification, the loan's net carrying amount is as follows.

Par value of debt	\$1,000,000
Unaccreted discount on the loan	(6,000)
Unaccreted third-party debt issuance costs	(4,000)
Net carrying amount of debt	<u>\$ 990,000</u>

Analysis #1: Cash flow test

First, Debtor schedules out all of the contractual cash flows under the new debt instrument, including cash paid to or received from the lender on the modification date. Those cash flows, which exclude-third party costs, are as follows.

Modification fee	\$ 10,000
Interest payments (\$1,000,000 × 4% × 3 years)	120,000
Repayment of principal	1,000,000
Total future cash flows	<u>\$1,130,000</u>

Debtor is required to discount the cash flows using the effective interest rate, for accounting purposes, of the original debt instrument, which was 2.65% (rounded). Note that Debtor's accounting policy is to use the effective interest rate of the original debt instrument excluding the third-party debt issuance costs when performing the cash flow test.

Present value of cash flows of new debt ¹	\$ 1,048,000
Present value of cash flows of original debt ²	(994,000)
Difference	<u>\$ 54,000</u>
	Change
Change in cash flows: $(\$1,048,000 - \$994,000) \div \$994,000$	5.4%
Notes:	
1. Discounted at the 2.65% effective interest rate of the original debt. Debtor does not discount the \$10,000 cash outflow (modification fee) on January 1, Year 5 because it was paid on the modification date.	
2. Calculated as \$1 million principal amount – \$6,000 unaccreted discount; debt issuance costs are excluded per policy election.	

Because the change in the present value of cash flows is less than 10%, Debtor moves to Analysis #2.

Analysis #2: Conversion option fair value test

Debtor compares the change in the fair value of the embedded conversion option after the modification to the carrying amount of the original convertible debt instrument immediately before the modification.

Increase in fair value of embedded conversion option after modification ¹	\$ 80,000
Carrying amount of original convertible debt before modification ²	<u>(994,000)</u>
	Change
Change in cash flows: $\$80,000 \div \$994,000$	8.05%
Notes:	
1. \$105,000 fair value of the embedded conversion feature in the new debt – \$25,000 fair value of the embedded conversion feature in the old debt at the date of modification.	

2. Calculated as \$1 million principal amount – \$6,000 unaccreted discount; debt issuance costs are excluded per policy election.

Debtor determines the change in the present value of the cash flows is less than 10%.

Analysis #3: Addition or elimination of a substantive conversion option

The modification in this example neither added nor eliminated a substantive conversion option.

Debtor concludes that the terms of the new convertible debt instrument are not substantially different, and therefore applies modification accounting. Debtor records the debt modification and related third-party costs in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Convertible note (discount on convertible note)	90,000	
Cash		10,000
APIC		80,000
<i>To recognize increase in fair value of conversion option and modification fee paid to creditor.</i>		
Debt modification expense ¹	13,000	
Cash		13,000
<i>To recognize third-party costs related to modification.</i>		
Note:		
1. Under subparagraph 470-50-40-18(a) third-party costs related to the modification are expensed as incurred because the modification was not substantial.		

If this convertible debt modification had decreased the fair value of the embedded conversion option, Debtor would not have increased the carrying amount of the convertible debt for that change in fair value based on the guidance in paragraphs 470-50-40-14 and 40-15.

Effective interest rate subsequent to the modification

Debtor determines that the effective interest rate for the new debt instrument is 7.9% based on:

- \$900,000 adjusted net carrying amount of the original debt instrument (\$1 million principal amount – \$10,000 modification fee – \$6,000 unaccreted discount – \$4,000 unaccreted debt issuance costs – \$80,000 increase in the fair value of the embedded conversion option resulting from the modification); and
- the revised cash flows of the new debt instrument.

4.6.30 Accounting for fees and issuance costs when modification accounting is applied



Excerpt from ASC 470-50

> Fees between Debtor and Creditor

40-17 Fees paid by the debtor to the creditor or received by the debtor from the creditor (fees may be received by the debtor from the creditor to cancel a call option held by the debtor or to extend a no-call period) as part of the exchange or modification shall be accounted for as follows: ...

- b. If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the fees shall be associated with the replacement or modified debt instrument and, along with any existing unamortized premium or discount, amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the interest method.

For fees between the debtor and creditor for exchanges of or modifications to line-of-credit or revolving-debt arrangements, see paragraph 470-50-40-21.

40-17A An increase or a decrease in the fair value of a freestanding equity-classified written call option held by a creditor (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a debt instrument held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17i) shall be accounted for in the same manner as fees between the debtor and the creditor as described in paragraph 470-50-40-17.

> Third-Party Costs of Exchange or Modification

40-18 Costs incurred with third parties directly related to the exchange or modification (such as legal fees) shall be accounted for as follows:...

- c. If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the costs shall be expensed as incurred.

For third-party costs for exchanges of or modifications to line-of-credit or revolving-debt arrangements, see paragraph 470-50-40-21.

40-18A An increase (but not a decrease) in the fair value of a freestanding equity-classified written call option held by a third party (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a debt instrument (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)) shall be accounted for in the same manner as third-party costs incurred that are directly related to the modification or exchange of a debt instrument as described in paragraph 470-50-40-18.



Question 4.6.40

How does a debtor account for fees and costs related to a debt modification under modification accounting?

Interpretive response: How a debtor accounts for fees related to a debt modification depends on who it pays the fees to – the creditor or a third party. The following table summarizes how the debtor accounts for such fees as well as any unaccreted discounts, premiums and debt issuance costs. [470-50-40-17 – 40-18]

Fees and costs	Nonsubstantial modification (modification accounting)
Unaccreted/unamortized discounts, premiums and debt issuance costs	Any existing unamortized/unaccreted premium, discount, or issuance costs are amortized/accreted as an adjustment of interest expense over the remaining term of the modified debt instrument using the new effective interest rate. [470-50-40-17(b)]
Fees paid to or received from creditors	Such fees are deferred by recording them as a decrease or increase in the debt's net carrying amount. They are subsequently recognized in interest expense using the new effective interest rate. [470-50-40-17(b)]
Fees paid to third parties	Such costs are expensed as incurred. [470-50-40-18(b)]

See also Question 4.6.45 when a freestanding equity-classified written call option modification or exchange is a part of or directly related to a modification or an exchange of the existing debt instrument.



Question 4.6.45

How does a debtor account for a modification or exchange of a freestanding equity-classified written call option associated with a debt modification under modification accounting?

Interpretive response: If a modification of a freestanding equity-classified written call option is in the scope of paragraphs 815-40-35-14 to 35-17 (see section 8.13.40), how the debtor recognizes and measures the modification's effect depends on whether the written call option is held by the creditor or a third party.

The following table summarizes how the debtor measures and recognizes that effect. [470-50-40-17A, 40-18A]

Holder of written call option	Accounting treatment
Creditor	The changes in the written call option's fair value (increases and decreases) are deferred by recording them as a decrease or increase

Holder of written call option	Accounting treatment
	in the debt's net carrying amount. They are subsequently recognized in interest expense using the new effective interest rate – i.e. treated as fees paid to or received from the creditor; see Question 4.6.40. [470-50-40-17A]
Third party	Any increases (but not decreases) in the written call option's fair value are expensed as incurred – i.e. treated as fees paid to third parties; see Question 4.6.40. [470-50-40-18A]



Question 4.6.50

How does a debtor classify in the income statement third-party costs incurred for a modification that is not substantial?

Interpretive response: There is no specific accounting guidance on the income statement classification of an expense resulting from transaction costs incurred to third parties related to a modification that is not substantial. Because the Subtopic requires the debtor to expense the costs immediately, they are not associated with either the original debt or the modified debt for accounting purposes. Therefore, we believe it may be appropriate to include these costs in an income statement line item other than interest expense.

Question 4.4.80 discusses how a debtor treats costs of the creditor that it pays directly.



Question 4.6.60

How are modification fees paid to a creditor as part of an equity offering accounted for?

Background: An entity pays a fee to a creditor for certain changes to its credit facility to consummate an equity offering. The changes to the terms of the facility do not substantially change the cash flows under the facility; therefore, the changes are a modification and not an extinguishment.

Interpretive response: Fees paid to creditors to modify debt arrangements are accounted for prospectively as an adjustment to the effective interest rate regardless of the reason for modification. This means they are recorded as an additional debt discount and expensed over the remaining term of the credit facility using the effective interest method. [470-50-40-17]

Although paragraph 340-10-S99-1 permits direct and incremental costs associated with an IPO to be deferred and charged against the gross proceeds of the offering, the deferred costs are limited to the direct incremental transaction costs of the offering, such as legal, accounting and underwriter fees. Other costs indirectly related to the offering are not charged against the

offering's gross proceeds. Indirect costs include costs related to debt modification, employee termination, hiring key management, gains and losses attributed to closing facilities and changing the entity's legal structure.

4.7 Non-TDR debt restructurings involving a loan participation or loan syndicate



Excerpt from ASC 470-50

> Implementation Guidance

• > Identification of Debtor and Creditor

55-1 Based on the definition of a **loan participation**, for purposes of applying the guidance in this Subtopic, the debt instrument would be the contract between the debtor and the lead bank. Participating banks are not direct creditors but, rather, have an interest represented by a certificate of participation. In the event of a modification or exchange between the debtor and lead bank, the debtor shall apply the guidance in this Subtopic.

55-2 Based on the definition of a **loan syndication**, for purposes of applying the guidance in this Subtopic, separate debt instruments exist between the debtor and the individual creditors participating in the syndication. If an exchange or modification offer is made to all members of the syndicate and only some of the creditors agree to the exchange or modification, the guidance in this Subtopic would be applied to debt instruments held by those creditors that agree to the exchange or modification. Debt instruments held by those creditors that do not agree would not be affected.

Loan participations and loan syndications involve multiple creditors. Generally, in practice, loan syndications are more common. When these arrangements are restructured, the debtor needs to identify the creditor relationship to be analyzed as follows. [470-50-55-1 – 55-2]

Loan participation

In a loan participation, a single lender (the lead bank) makes a large loan to a debtor and subsequently transfers undivided interests in the loan to other banks or entities. For accounting purposes, participating banks are not direct creditors but instead have an interest represented by a certificate of participation. In a modification or exchange of the contract between the debtor and the lead bank, the debtor applies the nonconvertible debt model in Subtopic 470-50 (i.e. the cash flow test) to determine if the modification or exchange is substantial (see section 4.4).

A debtor determines whether it obtains its loan from a single lender (participation) or from multiple lenders (syndicate) based on an evaluation of the legal terms and substantive conditions of the arrangement.

Loan syndication	Debtors often borrow amounts greater than what a single creditor is willing to lend. Therefore, it is common for groups of creditors to jointly fund such loans. This may be accomplished through a syndication, in which several creditors share in lending to a single debtor. In a syndication, each creditor loans a specific amount to the debtor and has the right to repayment from the debtor. In a modification of the loan, the debtor performs a separate cash flow analysis for each individual creditor in the syndicate because each creditor has loaned a specific amount to the debtor and possesses its own right to repayment. The accounting for unaccreted fees and new fees related to modified debt terms in a syndicated lending relationship is the same as debt not involving a bank syndicate.
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Question 4.7.10

If a creditor withdraws from a syndicate in connection with a debt restructuring, is the debt instrument held by the withdrawing creditor extinguished?

Interpretive response: Yes. If a creditor(s) leaves the bank syndicate in connection with a debt modification or exchange, the debtor accounts for the debt instrument(s) previously held by the withdrawing creditor(s) as extinguished because the obligation to the withdrawing creditor(s) is paid, which relieves the debtor of its obligation to that creditor. [405-20-40-1]

New fees paid to creditors leaving the syndicate are associated with the extinguishment of the original debt and are included in determining the extinguishment gain or loss. Further, a portion of any unaccreted/unamortized debt discount (or premium) and debt issuance costs on the overall syndicate borrowings are allocated to the debt held by the withdrawing creditor(s) to determine the net carrying amount of that debt when recognizing the gain or loss on extinguishment. The allocation of the unaccreted discount (or unamortized premium) and unaccreted debt issuance costs to the debt held by the withdrawing creditor(s) is often determined based on the ratio of the principal balance of the debt held by that creditor(s) to the overall principal balance held by the bank syndicate.

If the debt previously held by the withdrawing creditor(s) is refinanced with other existing syndicate lenders, that refinancing is accounted for as a modification or extinguishment, depending on the results of the cash flow test for each of the syndicate lenders. If the debt previously held by the withdrawing creditor(s) is refinanced with a new syndicate lender(s), it is accounted for as a new borrowing.



Question 4.7.20

If a debt restructuring involves multiple debt instruments with the same creditor or creditor group, are the cash flows analyzed individually or on a consolidated basis?

Interpretive response: If a debt modification or exchange involves multiple term debt instruments with the same creditor, we believe that the debtor generally should perform the cash flow test under the nonconvertible debt model on a compound basis using the cash flows for all outstanding term debt instruments with that creditor before and after the modification.

Similarly, if a debt modification or exchange involves multiple lines-of-credit or revolving-debt arrangements with the same creditor, we believe that the debtor generally should perform the borrowing capacity test under paragraph 470-50-40-21 on a compound basis using the commitments and terms for all outstanding lines-of-credit or revolving-debt arrangements with the creditor before and after the modification. The analyses of the accounting for a debt modification or exchange should be performed on a creditor-by-creditor basis in the case of a loan syndication.

When a debtor modifies multiple instruments with the same creditor or creditor group, such as a bank syndicate, a careful evaluation of all relevant facts and circumstances is necessary to determine the appropriate accounting treatment. For example, assume a credit facility that includes both term debt and a line of credit or a revolving debt arrangement is modified or exchanged. We believe it may be appropriate to apply the cash flow test to the term debt modifications (or exchanges) and the borrowing capacity test to the line-of-credit or revolving debt modifications (or exchanges) (see section 4.8) if:

- the facts and circumstances support the independence of the negotiations for each modified component; and
- the compensation paid to or received from the lender for each modified component is the same (e.g. a lender that has all components of the transaction is compensated for each one of those components identically to a lender who only holds one or less than all of the components).



Example 4.7.10

Modification of a revolving debt facility, including a change in composition of the bank syndicate

On January 1, Year 1, Debtor enters into an agreement for a \$10 million revolving credit facility with a syndicated group of creditors. The commitment by each lender in the syndicate is:

- Bank X – \$5 million
- Bank Y – \$3 million
- Bank Z – \$2 million.

4. TDRs, debt modifications and extinguishments

The term of the facility is four years. Debtor pays lender fees and incurs third-party transaction costs totaling \$200,000 that it is capitalizing and accreting over the four-year term.

Debtor immediately borrows the maximum amount available under the facility.

After one year, on January 1, Year 2, Debtor and the banks agree to modify the agreement by increasing the facility to \$15 million. The commitment by each bank after the modification is:

- Bank X – \$5 million
- Bank Z – \$2 million
- Bank N – \$8 million.

Debtor pays fees and other costs totaling \$100,000 to the creditors and third parties. However, Bank N joins the syndicate and funds from Bank N are used to repay the facility balance of Bank Y, who subsequently drops out of the syndicated group. Bank Y receives \$30,000 of the \$100,000 of total new fees paid by Debtor.

Debtor performs separate analyses of its borrowing capacity with Bank X and Bank Z (the continuing syndicate lenders) using the borrowing capacity test to determine whether any portion of the unaccreted deferred costs attributable to those lenders should be written off. Debtor's borrowing capacity with Bank X and Bank Z does not change (i.e. neither the remaining term of the arrangement nor the maximum available credit changes), so the remaining unaccreted deferred costs attributable to those lenders remain capitalized and will continue to be accreted over the term of the new arrangement. Debtor also defers and accretes the new fees paid to Bank X, Bank Z and Bank N over the term of the new facility.

The replacement of Bank Y results in an extinguishment of its portion of the outstanding loan at the date of the modification. Debtor records as an expense (as part of the loss on extinguishment) a proportionate share of the unaccreted debt issuance cost related to Bank Y's commitment in the original facility. The pro rata amount is based on Bank Y's commitment compared to the total amount of the credit facility (before the modification). Debtor also expenses the portion of the new fees that are paid to Bank Y, the withdrawing creditor (as part of the loss on extinguishment).

Debtor records the following journal entries for the \$100,000 of new lender fees and third-party costs incurred in connection with the loan modification as of January 1, Year 2 as well as the repayment of Bank Y with funds from Bank N.

	<i>Debit</i>	<i>Credit</i>
Loss on modification of debt	30,000	
Loan payable (debt issuance costs)	70,000	
Cash		100,000
<i>To recognize debt modification related costs.</i>		

4. TDRs, debt modifications and extinguishments

	<i>Debit</i>	<i>Credit</i>
Loan payable (Bank Y)	3,000,000	
Cash		3,000,000
<i>To recognize repayment of loan from Bank Y.</i>		
Cash	8,000,000	
Loan payable (Bank N)		8,000,000
<i>To recognize loan from Bank N.</i>		

The \$30,000 loss represents the portion of those fees paid to Bank Y. Debtor expenses the amount paid to Bank Y because it is no longer in the bank syndicate. The remaining \$70,000 in lender fees is capitalized and accreted over the term of the facility.

Debtor records the following journal entry to write off a portion of existing unaccreted debt issuance costs at the modification date.

	<i>Debit</i>	<i>Credit</i>
Loss on modification of debt	45,000	
Loan payable (net of debt issuance costs)		45,000
<i>To recognize writeoff of unaccreted issuance costs pertaining to Bank Y.</i>		

The loss amount represents Bank Y's proportionate share of the unaccreted debt issuance costs incurred when the original revolving credit facility was granted. The unaccreted debt issuance costs on the original debt immediately before the modification were \$150,000. Under the original arrangement, Bank Y's commitment was \$3 million of the \$10 million facility, or 30%. Therefore, the unaccreted debt issuance cost associated with Bank Y is \$45,000 (\$150,000 × 30%).

4.7.10 Transactions with third-party intermediaries



Excerpt from ASC 470-50

> Transactions Involving Third-Party Intermediaries

40-19 In transactions involving a third-party intermediary acting as agent on behalf of a debtor, the actions of the intermediary shall be viewed as those of the debtor in order to determine whether there has been an exchange of debt instruments or a modification of terms between a debtor and a creditor. Stated another way, if a third-party intermediary acts as agent, the analysis shall look through the intermediary.

40-20 In transactions involving a third-party intermediary acting as principal, the intermediary should be viewed as a third-party creditor similar to any other creditor in order to determine whether there has been an exchange of debt

instruments or a modification of terms between a debtor and a creditor. Stated another way, if a third-party intermediary acts as principal, the analysis should not look through the intermediary.

- > Exchanges or Modifications of Debt Involving a Third-Party Intermediary

55-4 In transactions involving a third-party investment banker acting as agent on behalf of the debtor, the activity of the investment banker is treated as if it were the activity of the debtor. Thus, if the investment banker acquires debt instruments from holders for cash, the debtor has an extinguishment even if the investment banker subsequently transfers a debt instrument with the same or different terms to the same or different investors. If the investment banker acting as agent on behalf of the debtor acquires instruments from holders by exchanging those instruments for new debt, the guidance in this Subtopic shall be applied. If the investment banker acquires debt instruments from holders for cash and contemporaneously issues new debt instruments for cash, an extinguishment has occurred only if the two debt instruments have substantially different terms, as defined in Section 470-50-40.

55-5 In transactions involving a third-party investment banker acting as principal, the investment banker is considered a debt holder like other debt holders. Thus, if the investment banker acting as principal acquires debt instruments from other parties, the acquisition by the investment banker does not impact the accounting by the debtor, and exchanges or modifications between the debtor and the investment banker shall follow the guidance in this Subtopic.

- > Transactions Among Debt Holders

55-6 If a debt instrument is transferred from one debt holder to another in connection with a modification or exchange, including transfers from an intermediary acting as principal to another debt holder, the debtor is not impacted by the exchange as long as the funds do not pass through the debtor or its agent.

- > Determination of Whether a Third-Party Intermediary Is an Agent or a Principal

55-7 Transactions between a debtor and a third-party creditor should be analyzed based on the guidance in paragraph 405-20-40-1 and the guidance in this Subtopic to determine whether gain or loss recognition is appropriate. Application of the guidance in this Subtopic may require determination of whether a third-party intermediary is an agent or a principal and consideration of legal definitions may be helpful in making that determination. Generally, an agent acts for and on behalf of another party. Therefore, a third-party intermediary is an agent of a debtor if it acts on behalf of the debtor. In addition, an evaluation of the facts and circumstances surrounding the involvement of a third-party intermediary should be performed. The following indicators should be considered in that evaluation:

- a. If the intermediary's role is restricted to placing or reacquiring debt for the debtor without placing its own funds at risk, that would indicate that the intermediary is an agent. For example, that may be the case if the intermediary's own funds are committed and those funds are not truly at risk because the intermediary is made whole by the debtor (and therefore is indemnified against loss by the debtor). If the intermediary places and

reacquires debt for the debtor by committing its funds and is subject to the risk of loss of those funds, that would indicate that the intermediary is acting as principal.

- b. In an arrangement where an intermediary places notes issued by the debtor, if the placement is done under a best-efforts agreement, that would indicate that the intermediary is acting as agent. Under a best-efforts agreement, an agent agrees to buy only those securities that it is able to sell to others; if the agent is unable to remarket the debt, the issuer is obligated to pay off the debt. The intermediary may be acting as principal if the placement is done on a firmly committed basis, which requires the intermediary to hold any debt that it is unable to sell to others.
- c. If the debtor directs the intermediary and the intermediary cannot independently initiate an exchange or modification of the debt instrument, that would indicate that the intermediary is an agent. The intermediary may be a principal if it acquires debt from or exchanges debt with another debt holder in the market and is subject to loss as a result of the transaction.
- d. If the only compensation derived by an intermediary from its arrangement with the debtor is limited to a preestablished fee, that would indicate that the intermediary is an agent. If the intermediary derives gains based on the value of the security issued by the debtor, that would indicate that the intermediary is a principal.



Question 4.7.30

How are third-party intermediaries considered when determining whether a modification or exchange of a debt instrument is an extinguishment?

Interpretive response: A modification or exchange of debt may involve an investment bank or other intermediary acting as an agent of the debtor or as a principal to the transaction. [470-50-55-4 – 55-5]

<p>Third-party intermediary acting as an agent</p>	<p>If the intermediary acts as an agent on behalf of the debtor, the actions of the intermediary are viewed the same as those of the debtor. In other words, the analysis looks through the intermediary to determine whether an extinguishment has occurred under Subtopic 470-50.</p>
<p>Third-party intermediary acting as a principal</p>	<p>A principal is considered to be a party to the transaction and is treated as a creditor. If the intermediary acts as a principal, the actions of the intermediary are viewed the same as those of a creditor. Therefore, when a third-party intermediary acts as a principal, the analysis does not look through the intermediary to determine whether an extinguishment has occurred under Subtopic 470-50.</p>

As a consequence, it is important to distinguish whether an intermediary is acting as an agent or a principal for the following two reasons.

Inclusion of fees in cash flow analysis	First, an entity must consider fees received from or paid to a creditor as a component of the cash flows when determining if the exchange or modification is substantial. However, an entity should not consider fees paid to a third party in the cash flow analysis.
Accounting for fees	Second, the accounting treatment of fees (i.e. defer and accrete or expense) paid to a creditor compared to a third party in connection with an exchange or modification differs. See section 4.5 for accounting for fees paid to or received from creditors and costs incurred to third parties in connection with a debt modification or exchange.



Question 4.7.40

How are fees paid to intermediaries for debt modifications accounted for?

Background: Debtor amends the terms of its syndicated debt facility. In connection with the amendment, Debtor pays the financial institution acting as administrative agent for the syndication group an 'arrangement fee'. Further, it pays a 'consent fee' of 0.125% of principal to the financial institution (in its role as administrative agent) that is passed through to each creditor in the syndicate based on each creditor's pro rata share of the total principal. The administrative agent is also the largest creditor in the syndicate and receives the 'consent fee' based on its pro rata share of the total principal, in addition to the 'arrangement fee.' Assume the amendment is treated as a modification based on the provisions of Subtopic 470-50.

Interpretive response: Under the provisions of Subtopic 470-50, when an amendment to a debt facility is accounted for as a modification (as opposed to an extinguishment), fees paid to an agent are expensed as incurred while fees paid to a creditor are capitalized and accreted as an adjustment of interest expense over the remaining term of the modified debt instrument using the effective interest method. [470-50-40-18(b)]

We believe that in this scenario, the financial institution, as intermediary, is acting as Debtor's agent in the modification with respect to the 'arrangement fee' and as a principal with respect to its pro rata share of the 'consent fee'. Its role in the context of the arrangement fee is that of an agent for the following reasons.

- To earn the administrative agent's arrangement fee, its responsibilities were restricted to asking all creditors to amend the terms of the debt and that action did not require it to place its own funds at risk, other than the funds it already had at risk in its capacity as creditor. Although it was a creditor in the syndicate in addition to being an agent, it did not place its funds at risk in the context of assisting Debtor effect the modification.
- The financial institution could not independently initiate a modification of the debt facility and was not subject to loss from doing so.

- The compensation derived from its arrangement with the other debtors is limited to a pre-established fee, which would indicate that the intermediary is an agent with respect to the arrangement fee.

As the financial institution also received a consent fee of 0.125% of its total principal as a creditor, which is the same fee received by all other creditors in the syndicate, it is considered a principal in the context of the consent fee and its role as a creditor (consistent with the other creditors in the syndicate).

Based on the above conclusion, Debtor treats the 'arrangement fee' as a fee paid to an agent (i.e. third-party costs that are expensed) and the 'consent fee' as a fee paid to a creditor (i.e. creditor fees that are deferred and accreted).

4.8 Non-TDR debt restructurings of line-of-credit or revolving-debt arrangements



Excerpt from ASC 470-50

> Line-of-Credit or Revolving-Debt Arrangements

40-21 Modifications to or exchanges of **line-of-credit or revolving-debt arrangements** resulting in either a new line-of-credit or revolving-debt arrangement or resulting in a traditional term-debt arrangement shall be evaluated in the following manner:

- a. The debtor shall compare the product of the remaining term and the maximum available credit of the old arrangement (this product is referred to as the borrowing capacity) with the borrowing capacity of the new arrangement.
- b. If the borrowing capacity of the new arrangement is greater than or equal to the borrowing capacity of the old arrangement, then any unamortized deferred costs, any fees paid to the creditor, and any third-party costs incurred shall be associated with the new arrangement (that is, deferred and amortized over the term of the new arrangement).
- c. If the borrowing capacity of the new arrangement is less than the borrowing capacity of the old arrangement, then:
 1. Any fees paid to the creditor and any third-party costs incurred shall be associated with the new arrangement (that is, deferred and amortized over the term of the new arrangement).
 2. Any unamortized deferred costs relating to the old arrangement at the time of the change shall be written off in proportion to the decrease in borrowing capacity of the old arrangement. The remaining unamortized deferred costs relating to the old arrangement shall be deferred and amortized over the term of the new arrangement.

Fees between the debtor and the creditor include an increase or a decrease in the fair value of a freestanding equity-classified written call option held by a creditor (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a line-of-credit or revolving-debt arrangement held by that same creditor (see

paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)). Third-party costs include an increase (but not a decrease) in the fair value of a freestanding equity-classified written call option held by a third party (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a line-of-credit or revolving-debt arrangement (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)).

For fees between the debtor and the creditor or third-party costs not related to exchanges of or modifications to a line-of-credit or revolving-debt arrangements resulting in either a new line-of-credit or revolving-debt arrangement, see paragraphs 470-50-40-17 through 40-18A.

40-22 The guidance in this Subtopic is limited to modifications to or exchanges of line-of-credit or revolving-debt arrangements by a debtor and a creditor (the same parties that were involved in the original line-of-credit or revolving-debt arrangement) in a nontroubled situation.

40-23 See Example 1 (paragraph 470-50-55-10) for an illustration of this guidance.

As discussed in section 4.4, modifications to nonconvertible and convertible debt instruments are subject to the cash flow test in paragraph 470-50-40-10 to determine if they are substantial. In contrast, modifications of lines-of-credit and revolving-debt arrangements are subject to the guidance in paragraph 470-50-40-21.

That guidance requires a debtor to determine the borrowing capacity of both the original arrangement and the new arrangement. An arrangement's borrowing capacity is determined by multiplying the arrangement's remaining term with the maximum available credit. [\[470-50-40-21\]](#)

The accounting for fees and costs when a line-of-credit or revolving debt arrangement is modified is summarized in the following table. [\[470-50-40-21\]](#)

<p>If borrowing capacity of the new arrangement is greater than or equal to the borrowing capacity of the old arrangement:</p>	<p>New fees paid to the creditor and third-party costs incurred are deferred and accreted over the term of the new arrangement.</p> <p>Unaccreted deferred costs relating to the old arrangement continue to be deferred and are accreted over the term of the new arrangement.</p>
<p>If borrowing capacity of the new arrangement is less than the borrowing capacity of the old arrangement:</p>	<p>New fees paid to the creditor and third-party costs incurred are deferred and accreted over the term of the new arrangement.</p> <p>Unaccreted deferred costs relating to the old arrangement are written off in proportion to the decrease in borrowing capacity of the old arrangement. The remaining unaccreted deferred costs are deferred and accreted over the term of the new arrangement.</p>

See also Question 4.8.30 when a freestanding equity-classified written call option modification or exchange is a part of or directly related to a modification or an exchange of an existing debt instrument.

**Question 4.8.10****Does the guidance in paragraph 470-50-40-21 apply when either the old or the new instrument is term debt?**

Interpretive response: We believe that paragraph 470-50-40-21 generally should be applied to an exchange of a line-of-credit or revolving-debt arrangement for term debt with the same creditor. In contrast, when a debtor exchanges term debt for a line-of-credit or revolving-debt arrangement with the same creditor, we believe that the guidance in paragraph 470-50-40-10 (i.e. the cash flow test) should be applied (see section 4.4).

**Question 4.8.20****Does the 'borrowing capacity' refer to the funds available to the debtor?**

Interpretive response: No. borrowing capacity is a key measure a debtor uses to determine the accounting for a modification to a line of credit or revolving debt arrangement with the same creditor. Borrowing capacity is the product of: (a) the maximum available credit and (b) the term of the arrangement. [470-50-40-21(a)]

The maximum available credit refers to the maximum funds available to the debtor. Borrowing capacity is a mathematical formula used to ascertain the magnitude of the modification. For example, an arrangement with a three-year life and a maximum draw of \$3 million provides for a borrowing capacity of \$9 million. The debtor uses a consistent unit of measure in calculating the borrowing capacity for each facility. For example, if the debtor expresses the term of the original borrowing arrangement in years, it also expresses the term of the new borrowing arrangement in years.

Subtopic 470-50's Example 1 (below) illustrates the guidance on accounting for modifications of line of credit or revolving debt arrangements.

**Excerpt from ASC 470-50**

> Illustrations

- > Example 1: Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements

55-10 This Example illustrates the application of the guidance in paragraphs 470-50-40-21 through 40-22 for changes in **line-of-credit or revolving-debt arrangements**.

55-11 Terms of original arrangement are as follows:

- Five-year term (three years remaining)
- \$10 million commitment amount
- The borrowing capacity under the original arrangement at the time of the change is \$30 million, the product of the remaining term (3 years) and the commitment amount (\$10 million).

55-12 The following situations represent changes that are made (with the same creditor) to the original terms:

- The commitment amount is increased to \$15 million, the term of the new arrangement remains at 3 years (borrowing capacity is \$45 million).
- The commitment amount is decreased to \$2 million, the term of the new arrangement is 5.5 years (borrowing capacity is \$11 million).
- The original revolver is replaced with a 3-year, \$7.5 million term loan, with principal due at the end of 3 years (borrowing capacity is \$22.5 million).
- The original revolver is replaced with a 3-year, \$10 million term loan, with principal due at the end of 3 years (borrowing capacity is \$30 million).

55-13 In all of the situations described, at the time the change is made to the original arrangement, \$150,000 of unamortized costs relating to the original arrangement remain on the debtor's balance sheet; the debtor pays a fee of \$100,000 to the creditor; and the debtor incurs third-party costs of \$200,000.

The following illustrates the various situations described in this Example.

Case	Old Borrowing Capacity	New Borrowing Capacity	Accounting Treatment of Unamortized Deferred Costs	Accounting Treatment of Fees and Third-Party Costs Incurred
A	30 million	45 million	\$150,000 is amortized over 3 years.	\$300,000 is deferred and amortized over 3 years.
B	30 million	11 million	63 percent of the unamortized costs (\$94,500) are written off; the remaining costs (\$55,000) are amortized over 5.5 years.	\$300,000 is deferred and amortized over 5.5 years.
C	30 million	22.5 million	25 percent of the unamortized costs (\$37,500) are written off; the remaining costs (\$112,500) are amortized over 3 years.	\$300,000 is deferred and amortized over 3 years.
D	30 million	30 million	\$150,000 is amortized over 3 years.	\$300,000 is deferred and amortized over 3 years.



Example 4.8.10

Modification of revolving credit facility (increase in borrowing capacity)

On January 1, Year 4, Debtor enters into a five-year revolving credit arrangement with Creditor, with a \$10 million commitment amount. Debtor incurs \$250,000 of third-party costs relating to the arrangement. Debtor Corp. accretes the third-party costs incurred on a straight-line basis over the term of the arrangement.

On January 1, Year 6, the parties modify the terms of the revolving credit arrangement to increase the commitment amount to \$15 million for the remaining three years of the arrangement. Debtor pays \$100,000 in fees to Creditor and \$200,000 in third-party costs relating to the modification of the revolving credit arrangement. At the time of the modification, Debtor had \$150,000 in unaccreted costs from the execution of the original credit arrangement.

Because the new credit facility's borrowing capacity of \$45 million (\$15 million commitment over three years remaining) is greater than the original facility's remaining borrowing capacity of \$30 million (\$10 million commitment over three years remaining), Debtor:

- continues to accrete the unaccreted deferred costs of \$150,000; and
- defers the fees paid to Creditor (\$100,000) and the third-party costs (\$200,000) incurred on modification. It accretes both costs on a straight-line basis over the three-year life of the new facility.



Example 4.8.20

Modification of revolving credit – decrease in borrowing capacity

On January 1, Year 1, Debtor enters into a five-year revolving credit arrangement with Creditor, with a \$10 million commitment amount. Debtor incurs \$250,000 of third-party costs relating to the arrangement. It accretes the third-party costs incurred on a straight-line basis over the term of the arrangement.

On January 1, Year 3, the parties modify the terms of the revolving credit arrangement to decrease the commitment amount to \$2 million and to extend the term of the facility until June 30, Year 8. Debtor pays \$100,000 in fees to Creditor and \$200,000 in third-party costs relating to the modification of the revolving credit arrangement. At the time of the modification, Debtor had \$150,000 in unaccreted costs from the execution of the original credit arrangement.

The original facility's remaining borrowing capacity was \$30 million (\$10 million commitment over the remaining three years), which is greater than the new borrowing capacity of \$11 million (\$2 million over the remaining 5.5 years). Because the borrowing capacity decreased as part of the modification, a pro rata portion of the unaccreted deferred costs relating to the original facility is written off. The borrowing capacity decreased by 63% (a \$19 million decrease), so 63% of the \$150,000 unaccreted deferred costs (\$94,500) is written off at the date of modification.

The remaining \$55,500 unaccreted deferred costs of the original facility, the \$100,000 fees paid to the creditor, and the \$200,000 third-party costs incurred on modification are accreted on a straight-line basis over the remaining life of the new facility (5.5 years).

**Example 4.8.30****Modification of revolving credit facility – exchange with term loan**

On January 1, Year 1, Debtor enters into a five-year revolving credit arrangement with Creditor, with a \$10 million commitment amount and a \$50 million borrowing capacity. Debtor incurs \$250,000 of third-party costs relating to the arrangement. Debtor accretes the third-party costs incurred on a straight-line basis over the term of the arrangement.

On January 1, Year 3, the parties modify the terms of the revolving credit arrangement to replace the existing revolving credit facility with a one-year \$22.5 million term loan. Debtor pays \$100,000 in fees to Creditor and \$200,000 in third-party costs relating to the modification of the revolving credit arrangement. At the time of the modification, Debtor had \$150,000 in unaccreted costs from the execution of the original credit arrangement.

We believe that paragraph 470-50-40-21 generally should be applied to an exchange of a line-of-credit or revolving-debt arrangement for term debt with the same creditor. Therefore, because Debtor exchanged a revolving credit arrangement for a term loan, it applies the capacity test (and not the cash flow test) to determine the effect of the modification.

The original facility's borrowing capacity was \$30 million (\$10 million commitment over the remaining three years) which is greater than the new borrowing capacity of \$22.5 million (\$22.5 million new term loan over the one year term). Because the borrowing capacity decreased by 25% (a \$7.5 million decrease), 25% of the \$150,000 unaccreted deferred costs (\$37,500) is written off at the date of modification. The remaining \$112,500 unaccreted deferred costs of the original facility, the \$100,000 fees paid to the creditor, and the \$200,000 third-party costs incurred on modification are accreted over the remaining life (three years) of the new term loan, using the effective interest rate method.

If the original credit facility is exchanged for a term loan with the same or greater borrowing capacity as the original credit facility, all of the unaccreted deferred costs of the original facility, the fees paid to the creditor, and third-party costs incurred on modification are accreted over the remaining life of the new facility.

**Question 4.8.30****How does a debtor account for a modification or exchange of a freestanding equity-classified written call option associated with a modified or exchanged line-of-credit or revolving-debt arrangement?**

Interpretive response: If a modification of a freestanding equity-classified written call option is in the scope of paragraphs 815-40-35-14 to 35-17 (see section 8.13.40), how the debtor measures the effect of the modification depends on whether the written call option is held by the creditor or a third

party. However, in all cases, that effect is deferred and accreted over the term of the new arrangement (i.e. treated as a fee paid).

The following table summarizes how the debtor measures and recognizes the effect. [470-50-40-21]

Holder of written call option	Accounting treatment
Creditor	The changes in the written call option's fair value (increases and decreases) are deferred and accreted over the term of the new arrangement.
Third party	Any increases (but not decreases) in the written call option's fair value are deferred and accreted over the term of the new arrangement.

4.9 Non-TDR restructurings of auction rate securities

ARS are securities whose interest or dividend rate resets periodically through a system called a Dutch auction, which is a competitive bidding process that determines the interest rate on each auction date. Traditional ARS are long-term securities with legal maturities of at least 20 years that have historically been marketed as liquid, short-term securities with interest rates that typically reset every week or month, or in some cases every 49, 60, or 90 days. ARS may also be issued in the form of mandatorily redeemable or perpetual preferred shares with dividend rates that reset periodically.

Entities in different industries can issue ARS backed by different asset classes. Municipalities, student-loan authorities, corporate entities and closed-end mutual funds are the primary issuers of ARS and use them to obtain long-term financing while targeting short-term investors. However, other ARS are issued by structured investment vehicles and collateralized by subprime mortgages and collateralized debt obligations (CDOs).

Existing holders of ARS have several choices at each auction date that primarily relate to the rate (interest rate for debt instruments or dividend rate for preferred shares) holders are willing to accept during the next period for the ARS. Holders may elect to:

- **Hold at market.** Hold the existing position regardless of the rate established in the upcoming auction (these instruments are not included in the auction);
- **Hold at rate.** Bid to hold the existing position at a specified minimum rate. If the clearing rate is below the bid-to-hold rate, the securities are sold;
- **Sell.** Offer to sell an existing position regardless of the interest rate set at the auction; or
- **Buy.** Submit a bid to buy a new position at a specified minimum interest rate (new buyers or existing buyers adding to their position at specified interest rate).

The clearing rate is the lowest bid rate at which (1) all potential sellers can sell their positions and (2) current holders can hold their positions. The clearing rate becomes the interest or dividend rate used for all securities until the next auction date. Absent a credit, liquidity or other factor, these securities typically sell at par because of the frequent repricing at auction. If there is a lack of demand and no established clearing rate, the auction fails, and the existing holders retain their positions at a rate set by using a formula established by the instrument's contractual terms. Often, these rates approximate a penalty rate that can be three to four times higher than a typical auction reset rate.

Failed auctions may have a variety of effects on an issuer's financial statements, including the following.

- **Extinguishment and/or modification of terms of ARS.** See further discussion below.
- **Balance sheet classification.** A failed ARS auction may represent an event of default that can trigger current classification or cross-defaults in other arrangements. For guidance on balance sheet classification of debt, see section 3.6.
- **Going concern analysis.** ARS issuances may have served as a significant source of liquidity for funding an issuer's current and long-term needs. Failed auctions may cause future issuances of ARS to no longer be an available source of funds. Further, failed auctions for outstanding ARS may lead to higher interest rates (significantly reducing income and liquidity) and/or represent events of default triggering current classification or cross-defaults in other arrangements. These factors may affect an ARS issuer's ability to continue as a going concern. KPMG Handbook, [Going concern](#), explains how an entity's management performs a going concern assessment and makes appropriate disclosures.
- **Hedge accounting:** An ARS issuer may be hedging the variability in the future interest cash flows, and the effects of failed auctions may affect any related hedge accounting. See Chapters 9 and 10 about cash flow hedging relationships in KPMG Handbook, [Derivatives and hedging](#).

Extinguishments of ARS

Whether ARS are accounted for as debt or equity-classified preferred shares determines the accounting for an extinguishment:

- **Debt.** The issuer accounts for the extinguishment under the guidance in paragraph 470-50-40-2 (see section 4.5).
- **Equity-classified preferred share.** The issuer accounts for the extinguishment under paragraph 260-10-S99-2 (see section 5.4.60).

Entities in different industries can issue ARS backed by different asset classes. Municipalities, student-loan authorities, corporate entities, and closed-end mutual funds are the primary issuers of ARS and use them to obtain long-term financing while targeting short-term investors. However, other ARS are issued by structured investment vehicles and collateralized by subprime mortgages and collateralized debt obligations (CDOs).

Extinguishments of ARS

An ARS's form (debt or preferred shares) determines the accounting for an extinguishment. If an issuer extinguishes ARS in the form of debt, it accounts for the extinguishment under the guidance in paragraph 470-50-40-2 (see section 4.5). If an issuer extinguishes ARS issued in the form of a preferred share, it accounts for the extinguishment under paragraph 260-10-S99-2 (see section 5.4.60).

Modifications of ARS

Debt

An issuer may decide to modify the terms of the ARS – e.g. by negotiating a change to the failed auction default interest formula or interest index. If the contractual terms of an existing ARS are modified, the issuer applies the cash flow test to determine whether to account for the change as an extinguishment or a modification (see section 4.4). Changes in contractual terms that are permitted within the ARS indenture (i.e. without negotiation or agreement by the holders) are not subject to evaluation under the cash flow test. Instead, changes that the issuer can make unilaterally within the original provisions of the ARS debenture are automatically accounted for as modifications for accounting purposes, not as extinguishments.

When the cash flow test applies, paragraph 470-50-40-10 requires extinguishment accounting if the difference between the present value of the cash flows associated with the original instrument and those associated with the modified instrument exceeds 10%. However, paragraph 470-50-40-10 applies only when a modification or exchange is between the issuer (or an intermediary or agent acting on the issuer's behalf) and an existing creditor, including an investment bank or other intermediary that is acting as a principal. If the modification process involves the issuer calling the debt from the existing creditor without a contemporaneous reissuance to the same creditor, paragraph 470-50-40-10 generally would not apply. See additional discussion under Question 4.9.20 regarding mandatory tender options.

Equity-classified preferred shares

If equity-classified preferred shares are modified, the issuer can either qualitatively or quantitatively assess new, removed and changed contractual terms to determine modification or extinguishment as further discussed in section 5.4.60.



Question 4.9.10

How is prepaid bond insurance accounted for when it relates to an ARS that has been restructured?

Interpretive response: Many ARSs are guaranteed by a third party, typically known as a bond insurer. If a restructuring arrangement allows for the legal preservation of the bond insurance but results in an extinguishment of the ARS for accounting purposes, we believe that the issuer may not be required to write off the carrying amount of the prepaid bond insurance (i.e. unaccreted guarantee fees) if:

- reissuance of the ARS under its original indenture is probable within a foreseeable period; and
- the insurer continues to provide coverage following reissuance.

If continued recoverability of the bond insurance can be supported following the extinguishment of the ARS, we believe that the issuer should perform a one-time only remeasurement of the prepaid asset by comparing the carrying amount to the current fair value of the bond insurance. If the prepaid bond insurance is not written off, the issuer continues to accrete those fees over the original term (unless the refinancing has affected the insurance term).



Question 4.9.20

How does a mandatory tender option affect the characterization of a restructured ARS?

Background: Generally, ARSs have contractual terms in existing agreements that may allow the issuer to change certain features of the ARS, such as the length of the auction period, date of the auction, or the interest mode (i.e. a change from the Dutch auction interest reset process to another process such as converting the interest rate to a fixed rate or an indexed rate), subject to fulfillment of certain contractual requirements before the change becomes effective. Some of these contractual changes specified in the securities indenture could trigger the exercise of a mandatory tender option. When a mandatory tender option is exercised, the holder of the security is required to surrender the security to the issuer or its agent (e.g. a tender agent) for purchase. The purchase price typically is at par. A change in the length of the auction period, or the date of the auction would typically not require a mandatory tender while an interest mode change generally would.

Interpretive response: If an issuer invokes a term in an existing ARS agreement that requires the holder of the security (the lender) to surrender the security to the issuer or its agent (i.e. the exercise of a mandatory tender option), we believe that the issuer should record an extinguishment for accounting purposes. Mandatory tender options, like traditional call options, are options held by the issuer that unilaterally permit the issuer to terminate an existing borrowing relationship with a current lender, and results in the lender being repaid the principal amount. While the specific facts and circumstances must be considered, the intermediary entity repurchasing the debt on the exercise of a mandatory tender option will generally be considered to be an agent for the issuer.

4.10 Extinguishments of debt instruments and other liabilities (other than debt restructurings)

4.10.10 Extinguishment of debt instruments and other liabilities (general model)



Excerpt from ASC 405-20

05-2 An entity may settle a liability by transferring assets to the creditor or otherwise obtaining an unconditional release. Alternatively, an entity may enter into other arrangements designed to set aside assets dedicated to eventually settling a liability. Accounting for those arrangements has raised issues about when a liability should be considered extinguished. This Subtopic establishes standards for resolving those issues.

40-1 Unless addressed by other guidance (for example, paragraphs 405-20-40-3 through 40-4 or paragraphs 606-10-55-46 through 55-49), a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
 1. Delivery of cash
 2. Delivery of other financial assets
 3. Delivery of goods or services
 4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this Subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

40-2 If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment. See Topic 460 for accounting guidance related to guarantees.

- • > Transfers of Noncash Financial Assets in Settlement of a Creditor's Receivable

55-5 A cash payment or conveyance of noncash financial assets from a debtor to a creditor results in full or partial settlement of the creditor's receivable from the debtor. Whether or not that settlement is an extinguishment is governed by paragraph 405-20-40-1. However, if a noncash financial asset was conveyed to the creditor in full or partial settlement of a creditor's receivable, it would be rare to conclude that debt has been extinguished if the criteria of paragraph 860-10-40-5 were not also met.

- • > Extinguishment Via Legal Defeasance

55-9 In a legal defeasance, generally the creditor legally releases the debtor from being the primary obligor under the liability. Liabilities are extinguished by legal defeasances if the condition in paragraph 405-20-40-1(b) is satisfied. Whether the debtor has in fact been released and the condition in that paragraph has been met is a matter of law. Conversely, in an in-substance defeasance, the debtor is not released from the debt by putting assets in the trust. For the reasons identified in paragraph 405-20-55-4, an in-substance defeasance is different from a legal defeasance and the liability is not extinguished.

Generally, an entity may settle a liability by transferring assets to the creditor or otherwise obtaining an unconditional release of the obligation. The primary issue when an instrument is settled generally is whether the settlement represents an extinguishment transaction.

If it is determined that a settlement represents an extinguishment transaction, the debtor calculates any gain or loss on extinguishment as the difference between the net carrying amount of the debt and the reacquisition price. See Question 4.5.20.



Question 4.10.10

Does the transfer of collateral to a creditor extinguish the debt?

Background: Debt may be secured by collateral that provides security to the creditor in the event of a default. For example, a loan may be secured by collateral such as securities (e.g. shares or bonds) or real estate. If a default occurs, the creditor can demand that the debtor transfer the collateral to the creditor.

Interpretive response: It depends. Transferring collateral does not generally release the debtor from its obligation. Transferring collateral to a creditor does not result in extinguishment of the debt unless the debtor is legally released as the primary obligor. To be released, the debt instrument must specify the circumstances in which the debtor is released as the primary obligor for the obligation on transfer of the collateral to the creditor. [\[405-20-40-1\]](#)

For example, non-recourse debt is debt for which the creditor agreed, as part of the original loan negotiations, to accept only the property being financed as

security for the debt and the creditor cannot look to any of the debtor's other assets to satisfy the debt. Therefore, if an entity transfers the collateral to the creditor, the debtor may be legally released as the primary obligor for the debt. This would result in the debt being extinguished.

A general recourse obligation may also be considered nonrecourse if the debtor does not have other substantive assets.

Topic 360 (property, plant, and equipment) provides guidance on determining whether real estate (including in-substance real estate) that has been conveyed to a lender should be derecognized and, accordingly, whether the liability has been extinguished.



Question 4.10.15**

Does a debtor account for a third party's agreement to pay its debt as an extinguishment of that debt?

Background: In certain instances, a debtor pays a third party in exchange for that party's agreement to make scheduled debt payments to a creditor. Such arrangements may involve the debtor transferring high-quality financial assets or cash to an irrevocable trust in an amount sufficient to service the debt, with the trust agreeing to service the debt with the transferred assets. In some cases, the creditor agrees to release the borrower as the primary obligor; in these cases, the creditor may require the debtor to remain secondarily liable.

Interpretive response: It depends. Since the creditor has not been repaid, an extinguishment will result only if both conditions in the following table are met.

Conditions that must be met	Commentary
The debtor is legally released from being the primary obligor of the debt (either judicially or by the creditor).	Whether a debtor has been legally released as the primary obligor is a legal determination that may require the debtor to obtain a legal opinion. If the debtor is not legally released as the primary obligor, the debt is not extinguished and the debtor continues to recognize the debt. See Question 4.10.110 for differences in derecognition accounting for an in-substance defeasance. [405-20-40-1]
The debtor does not consolidate another entity that represents a replacement primary obligor.	For example, if a trust becomes the primary obligor, the debtor's consolidated financial statements would continue to reflect the debt obligation if the debtor consolidates the trust. See KPMG Handbook, Consolidation , for additional guidance.

However, for extinguishment accounting to apply when the debtor transfers financial assets to an unconsolidated entity, the criteria for sale accounting under Topic 860 have to be met. If they are not met, the debtor continues to recognize the transferred assets (and a related liability). This is the case even if the conditions in the table above are met. See KPMG Handbook, [Transfers and](#)

[servicing of financial assets](#), for further guidance on consolidation and control of financial assets.

Accounting when the debt is extinguished

If a debtor concludes it has been released as the primary obligor (i.e. a novation or legal defeasance of the debt) and it does not consolidate another entity that represents a replacement primary obligor, extinguishment accounting applies. In that situation, the debtor evaluates whether it has become secondarily liable for the obligation. If so, it recognizes a guarantee obligation that either reduces the gain or increases the loss recognized on extinguishment of the liability.

Under Topic 460, a guarantor initially measures the guarantee obligation at its fair value plus:

- if the guarantee is in the scope of Subtopic 326-20: an expected credit loss liability; or
- if the guarantee is not in the scope of Subtopic 326-20: the excess, if any, of a contingent liability measured under Subtopic 450-20 over the guarantee's fair value.

See Topic 460 for guidance on accounting for guarantees and chapter 14 of KPMG Handbook, [Credit impairment](#), for guidance on measuring guarantees with expected credit losses. [\[405-20-40-2\]](#)



Question 4.10.16**

Does an entity derecognize a liability if it has insurance to cover the loss?

Interpretive response: No, not unless the entity is legally released from being the primary obligor for the liability (either judicially or by the creditor). The existence of an insurance policy that covers an obligation (loss) typically does not result in the creditor or plaintiff legally releasing the insured from being the primary obligor. Therefore, insurance coverage typically does not result in the nonrecognition or derecognition of a covered liability. [\[405-20-40-1\]](#)

Instead, the entity recognizes its liability and determines whether it is appropriate to recognize a receivable for the insurance recovery. The liability and, if recognized, the related insurance receivable do not satisfy the right of setoff requirements (e.g. they are typically not with the same counterparty) and therefore cannot be offset on the balance sheet (see section 3.4 of KPMG Handbook, [Financial statement presentation](#)).



Question 4.10.20

Are management's intentions evaluated in determining debt extinguishment?

Interpretive response: No. Management's intent to extinguish the debt is insufficient to consider the debt extinguished, even if management publicly

announces its intentions. Further, even if a debtor has a binding agreement to extinguish the debt or an entity intends to default on non-recourse debt with a subsequent transfer of the collateral to the creditor, the debt is not considered extinguished. In each of these situations, the debtor has neither paid the creditor nor been legally released by the creditor. An entity with non-recourse debt must default on the debt and must legally transfer the collateral before the debt is extinguished. [405-20-40-1]

The debtor continues to accrue interest on the debt until the debt is extinguished, even if it intends to default on the debt and to never pay the interest. If it accrues but does not pay the interest, it increases the gain or reduces the loss recognized on extinguishment.

A debtor may not be required to accrue interest on the debt if it is reorganizing under the US Bankruptcy Code. Certain provisions of the Bankruptcy Code may relieve the debtor from its obligation to pay interest. See also KPMG Handbook, [Accounting for bankruptcies](#).



Example 4.10.10

Extinguishing debt by transferring collateral to the creditor

On January 1, Year 1, Debtor borrows \$1 million from Creditor using the non-recourse loan to purchase real estate for \$1.1 million. The real estate being financed is the only security for the debt; Creditor cannot look to Debtor's other assets in the event of default.

- The loan has a maturity date of January 1, Year 5.
- Interest of \$100,000 is due on January 1 annually.

On July 1, Year 4, six months before the loan matures, Debtor determines the value of the real estate has been impaired and reduces the book value of the real estate to \$950,000, its estimated fair value. Debtor also contacts Creditor about a possible default on the debt and its intent to transfer the real estate to Creditor instead of repaying the loan in cash. On January 1, Year 5, Debtor defaults on the loan and transfers the real estate to Creditor.

Even though Debtor notifies Creditor of its intent to not repay the loan on maturity, it records interest expense until the debt is extinguished and it is legally released from its obligation. On the transfer of the real estate to Creditor, Debtor is released of its debt obligation and recognizes a gain computed as follows.

Carrying amount of note	\$1,000,000
Accrued interest payable	100,000
Carrying amount of real estate transferred ¹	(950,000)
Gain on debt extinguishment	\$ 150,000

Note:

1. This amount also is the current fair value of the real estate due to the recent recognition of impairment.

Debtor records the extinguishment as of January 1, Year 5 in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Notes payable ¹	1,000,000	
Accrued interest ²	100,000	
Real estate ³		950,000
Gain on extinguishment of debt ⁴		150,000
<i>To recognize transfer of real estate and debt extinguishment.</i>		
Notes:		
1. To remove the notes payable when Debtor is released of the obligation on transfer of the real estate.		
2. To remove the accrued interest, which was payable on January 1, Year 5.		
3. To recognize the transfer of the real estate to Creditor (at carrying amount).		
4. The gain on debt extinguishment is computed as the difference between the carrying amount of the debt plus accrued interest (\$1.1 million) and the carrying amount of the real estate (\$950,000).		

Examples 4.10.11 to Example 4.10.13 illustrate the computation of gain or loss in a debt extinguishment transaction.



Example 4.10.11^^

Extinguishment through prepayment of note payable – loss on extinguishment

On January 1, Year 4, Debtor borrows \$1 million from Bank.

- The loan has a 10-year term and bears interest at 8%, payable annually on December 31.
- Debtor may prepay the note for its principal amount plus 1% (issuer call option) at any time after three years. The call option does not require bifurcation as a derivative under Topic 815.
- Debtor pays a \$50,000 lender fee to Bank at inception of the loan, which it accounts for as a debt discount, and incurs \$30,000 of debt issuance costs with third parties.

Debtor records the borrowing and related debt issuance costs as of January 1, Year 4 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash ¹	950,000	
Loan payable (discount on loan payable) ¹	50,000	
Loan payable ¹		1,000,000
<i>To recognize debt and discount on debt.</i>		

4. TDRs, debt modifications and extinguishments

	<i>Debit</i>	<i>Credit</i>
Loan payable (debt issuance costs) ²	30,000	
Cash ²		30,000
<i>To recognize debt issuance costs.</i>		
Notes:		
1. To record the loan payable of \$1 million, the net cash received (\$1 million less the \$50,000 lender fee paid), and the \$50,000 difference between the loan payable and cash received, which is recorded as a debt discount.		
2. To record the \$30,000 cash paid for debt issuance costs.		

Accretion of debt discount and debt issuance costs

Debtor accretes the \$50,000 debt discount and the \$30,000 of debt issuance costs using the effective interest method over the 10-year term of the borrowing. From January 1, Year 4 to December 31, Year 8, Debtor accretes \$29,000 of the debt discount and \$17,000 of the debt issuance costs into interest expense.

Repayment of loan

On January 1, Year 9, Debtor repays the loan for \$1.01 million (\$1 million principal amount plus 1%). Transaction costs associated with the repayment are insignificant.

Immediately before the repayment, the net carrying amount of the debt is as follows.

Par value of debt	\$ 1,000,000
Unaccreted discount on the loan	(21,000)
Unaccreted third-party debt issuance costs	(13,000)
Net carrying amount of debt	\$ 966,000

Accounting for debt extinguishment loss

Debtor's loss on debt extinguishment is \$44,000 (\$1.01 million reacquisition price less the \$966,000 net carrying amount). Debtor records the extinguishment of the loan as of January 1, Year 9 in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Loan payable ¹	1,000,000	
Loss on debt extinguishment ²	44,000	
Loan payable (discount on loan payable) ³		21,000
Loan payable (debt issuance costs) ³		13,000
Cash ⁴		1,010,000
<i>To recognize principal payment and loss on debt extinguishment.</i>		

Notes:

1. The principal balance remaining on the loan at December 31, Year 8.
2. The loss on extinguishment (difference between the net carrying amount of the loan of \$966,000 and the loan repayment amount of \$1.01 million).
3. The unaccreted discount and the debt issuance cost balance at December 31, Year 8.
4. Cash repayment of \$1.01 million at January 1, Year 9.



Example 4.10.12^^

Partial extinguishment through reacquisition of bonds in the market – loss on extinguishment

On January 1, Year 4, Debtor issues \$10 million of 20-year bonds (10,000 bonds with a par value of \$1,000 per bond) for \$9.8 million (\$980 per bond).

- The bonds have an 8% coupon and cash interest payments are made annually on December 31.
- The bondholder may redeem the bonds (i.e. put the bonds back to Debtor) for par at any time after seven years. The put option does not require bifurcation as a derivative under Topic 815.
- Debtor incurs \$300,000 of debt issuance costs to third parties.

Debtor records the issuance of the bonds and related debt issuance costs as of January 1, Year 4 in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash ¹	9,800,000	
Loan payable (discount on loan payable) ¹	200,000	
Loan payable ¹		10,000,000
<i>To recognize debt and discount on debt.</i>		
Loan payable (debt issuance costs) ²	300,000	
Cash ²		300,000
<i>To recognize debt issuance costs.</i>		

Notes:

1. To record the loan payable of \$10 million, and the cash received of \$9.8 million. The difference between the loan payable and cash received is recorded as a debt discount of \$200,000.
2. To record the \$300,000 cash paid for debt issuance costs.

Accretion of debt discount and debt issuance costs

Debtor accretes the \$200,000 debt discount and the \$300,000 of debt issuance costs using the effective interest method over the seven-year period to the earliest put date, as the creditor has the ability to require payment before the stated maturity date.

4. TDRs, debt modifications and extinguishments

From January 1, Year 4 to December 31, Year 8, Debtor accretes \$152,000 of the debt discount and \$228,000 of the debt issuance costs into interest expense.

Repurchase of bonds

On January 1, Year 9, Debtor repurchases 5,000 bonds (50% of the outstanding bonds) in the open market for \$5.4 million (\$1,080 per bond). Debtor calculates unaccreted amounts related to the repurchase as follows.

Unaccreted debt discount	\$48,000
Unaccreted third-party costs	\$72,000
Percentage of debt extinguished	50%
Proportionate unaccreted debt discount	$\$48,000 \times 50\% = \$24,000$
Proportionate unaccreted third-party costs	$\$72,000 \times 50\% = \$36,000$

Transaction costs associated with the repurchase are insignificant. Therefore, the net carrying amount of the repurchased debt and the loss on extinguishment are as follows.

Par value of debt	\$ 5,000,000
Unaccreted discount on the loan	(24,000)
Unaccreted third-party debt issuance costs	(36,000)
Net carrying amount of debt	4,940,000
Reacquisition price	(5,400,000)
Loss on debt extinguishment	\$ (460,000)

Accounting for debt extinguishment loss

Debtor records the extinguishment of the 5,000 bonds it reacquired on January 1, Year 9 in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Bonds payable ¹	5,000,000	
Loss on debt extinguishment ²	460,000	
Bonds payable (discount on bonds payable) ³		24,000
Bonds payable (debt issuance costs) ³		36,000
Cash ¹		5,400,000
<i>To recognize bond repurchase and related loss on debt extinguishment.</i>		
Notes:		
1. To extinguish the bonds payable for the 5,000 bonds (\$1,000 par value) repurchased for \$5.4 million.		
2. To record the loss on debt extinguishment (the difference between the net carrying amount of 50% of the bonds of \$4.94 million and the repurchase price of \$5.4 million).		

3. To write off the unaccreted debt discount and debt issuance costs associated with the 50% of the bonds repurchased on January 1, Year 9.

Debtor continues to accrete the unaccreted debt discount and debt issuance costs for the bonds that it did not reacquire using the effective interest method over the remaining two-year period until the earliest put date.



Example 4.10.13^^

Accounting for a premium to prepay a portion of the principal balance on a term loan – loss on extinguishment

On January 1, Year 1, Debtor enters into a \$20 million five-year term loan with Bank.

- The loan has a five-year term and bears interest at 8%, payable annually on December 31.
- Debtor pays a \$30,000 lender fee to Bank, which it accounts for as a debt discount, and incurs \$20,000 of debt issuance costs with third parties.
- The effective interest rate at issuance is 8.06%.
- Debtor may prepay the loan at any time at 101% of the prepaid principal balance.

On January 1, Year 3, Debtor elects to prepay \$5 million of the outstanding principal for \$5.05 million. At the date of the prepayment the carrying amount of the debt is \$19.97 million with unamortized discounts and issuance costs totaling approximately \$32,300.

Debtor's prepayment of \$5 million represents 25% of the outstanding principal and reduces the unaccreted debt discounts/issuance costs in the same proportion.

Debtor records the following journal entry as of January 1, Year 3 to recognize the partial extinguishment of debt and the loss on such extinguishment.

	<i>Debit</i>	<i>Credit</i>
Debt ¹	5,000,000	
Loss on extinguishment ²	58,000	
Cash ³		5,050,000
Debt (discount and issuance costs) ⁴		8,000
<i>To recognize principal payment and related loss on extinguishment.</i>		

Notes:

1. To record the extinguishment of the debt (principal of \$5 million). The portion of principal prepaid represents 25% of the outstanding principal.
2. To record the loss on extinguishment. The total loss includes a write off of 25% of the unaccreted discount at the date of repayment and the 1% premium of \$50,000.

3. To record the cash repayment of \$5 million, plus the 1% premium (\$50,000).
4. To record the portion of the unaccreted debt discount/issuance costs related to the debt that was extinguished as part of the prepayment. ($\$32,300 \times 25\% =$ approximately \$8,000).



Example 4.10.20

Debtor released as primary obligor but still guarantees the debt

On January 1, Year 1, Debtor purchases land for \$1 million from Creditor in exchange for a 10-year note. On January 1, Year 5, Debtor sells the land to Investor Limited for \$500,000 and the assumption of the note payable. Debtor and Creditor execute a novation, which releases Debtor as the primary obligor of the note. Creditor will agree to the terms of the novation only if Debtor guarantees the note for the remaining five-year term.

The fair value of the guarantee is \$200,000 (for the stand-ready obligation or the non-contingent aspect of the guarantee). An additional liability may need to be recorded for the current expected credit losses (the contingent aspect of the obligation) under Topic 326. Accounting for the contingent aspect of a financial guarantee is outside the scope of this Handbook. See section 14.4 of KPMG Handbook, [Credit impairment](#).

Debtor records the following journal entry on January 1, Year 5 to derecognize the note payable because it has been released as the primary obligor by Creditor and to recognize a liability for the guarantee.

	<i>Debit</i>	<i>Credit</i>
Notes payable ¹	1,000,000	
Cash ²	500,000	
Guarantee liability ³		200,000
Gain on sale of land ⁴		300,000
Land ⁵		1,000,000
<i>To recognize release as primary obligor and recognize guarantee liability.</i>		

Notes:

1. To remove the notes payable due to being released as primary obligor.
2. To record the cash received for the sale of the land.
3. To record the guarantee liability (measured at fair value of \$200,000).
4. The gain on the sale of the land is computed as the difference between the net proceeds received (\$1.3 million) and the carrying amount of the land (\$1 million). Net proceeds from the sale represents the \$500,000 cash, plus the release of debt of \$1 million, less the fair value of the guarantee.
5. To record the sale of the land (carrying amount).

**Question 4.10.25****Does an issuer recognize an asset when it purchases 'treasury bonds' if it intends to resell them?**

Background: An issuer may purchase its outstanding debt securities and not legally retire them because it intends to subsequently reissue (i.e. sell) the bonds. Debt securities held by their issuer are commonly referred to as 'treasury bonds'.

Interpretive response: No. An issuer's reacquisition of its own debt securities represents an extinguishment of debt, regardless of whether the securities are cancelled or held as 'treasury bonds'. As discussed in Question 4.10.20, management's intentions are not evaluated in determining whether debt is extinguished. [405-20-40-1(a)(4)]

Treasury bonds are not recorded on the balance sheet as a contra account because the debt has been extinguished and the liability has been derecognized. The issuer recognizes a gain or loss for the difference between the consideration paid to purchase the bonds and the carrying value of the bonds (including any related unamortized premiums, discounts or issuance costs). See section 4.10 on accounting for extinguishments of debt instruments and other liabilities. If the bonds are subsequently reissued, debt is recognized with the reissuance price as proceeds received.

**Example 4.10.25****Purchase of parent's debt securities by a broker-dealer subsidiary**

Parent Corp. consolidates Subsidiary, which is a broker-dealer. Subsidiary participates in trading activities, including taking positions in debt and equity securities, discounted acceptances, commercial paper and other traded financial instruments.

As part of these trading activities, Subsidiary creates a market in certain financial instruments to provide trading opportunities for its customers and to recognize trading profits. This includes periodically taking positions in Parent's debt securities by:

- buying Parent's debt securities from a customer who wants to sell them; and/or
- taking a temporary trading position from a noncustomer in the secondary market.

In both situations, Subsidiary holds the securities in its trading portfolio and intends to sell Parent's securities within a short time period.

Accounting in Subsidiary's stand-alone financial statements

When Subsidiary purchases Parent's debt securities, it records the position as a trading asset in its stand-alone financial statements because it does not have a recognized liability for Parent's outstanding debt obligation to extinguish.

Accounting in Parent's consolidated financial statements

Parent accounts for Subsidiary's purchase as an extinguishment of Parent's debt securities in Parent's consolidated financial statements.

In the consolidated financial statements, Parent records an extinguishment gain or loss for the difference between the consideration paid to purchase the bonds and the bonds' carrying amount (including a portion of any related unamortized premiums, discounts or debt issuance costs). If Subsidiary later resells Parent's debt securities, the resale is treated as a new issuance of Parent's debt securities in the consolidated financial statements.

Further, if Parent has designated any of the instruments (purchased by Subsidiary) in a hedging relationship under Topic 815 (derivatives and hedging), Parent considers whether the hedging relationship may continue or must be dedesignated or partially dedesignated on Subsidiary's acquisition date. See section 6.10 of KPMG Handbook, [Derivatives and hedging](#), about when a hedging relationship must be dedesignated.



Question 4.10.30

How does an entity allocate a single payment made to settle both its debt and repurchase its own equity?

Interpretive response: The general guidance in paragraph 470-50-40-2 indicates that if upon extinguishment of debt the parties also exchange stated rights (i.e. the equity instrument), the parties should also give appropriate accounting recognition to the portion of the consideration exchanged allocable to the stated rights. We believe that when a debtor makes a single payment to settle its outstanding debt and repurchase its own equity instruments from the same counterparty, the debtor should generally allocate the single payment to the multiple instruments being settled/repurchased (the debt instrument and the equity instrument) on a relative fair value basis (assuming both are carried on an amortized cost basis).



Example 4.10.30

Advanced bond refunding (debt defeasance)

In Year 1, Debtor (a non-SEC registrant) issues \$100 million of fixed-rate debt due in Year 20 with a coupon rate of 10% per annum (the Year 1 debt). The debt requires a 25% prepayment premium if the debt is prepaid before December 31, Year 11. The original debt agreement (the Year 1 bond indenture) included a defeasance provision allowing Debtor to transfer assets (cash, government securities or pre-refunded municipal obligations) sufficient to service the debt (including principal plus projected interest payments) to an irrevocable trust in full legal satisfaction of the debt obligation.

The bond indenture stated that "At such times as a Bond shall be deemed to be paid under this Indenture, as provided in this Defeasance section, such Bond

shall no longer be secured by or entitled to the lien or benefit of this Indenture". A prepayment penalty is not required to be paid in connection with a defeasance transaction.

As of December 31, Year 10 market interest rates had declined. As a result, Debtor enters into an advanced refunding transaction whereby it issues \$200 million in new fixed-rate debt due in Year 25 with a coupon rate of 5% per annum and uses \$110 million of the proceeds of the new debt offering to fund an unconsolidated irrevocable trust (the Trust) in satisfaction of the Year 1 debt.

Assume Debtor is not required to consolidate the Trust under the consolidation guidance in Topic 810, Subtopic 958-810 (regarding not-for-profit entities), or Subtopic 954-810 (regarding health care entities).

Because the irrevocable trust is not consolidated, Debtor evaluates if the conditions for derecognizing both the liability and the transferred assets are met.

Evaluating conditions for derecognizing the liability (extinguishment)

Paragraph 405-20-55-9 indicates that a legal defeasance results in extinguishment of the liability if the condition in paragraph 405-20-40-1(b) is met. The Year 1 bond indenture included a provision whereby the debt would be deemed paid if certain conditions were met (i.e. the bondholders had - in advance - agreed to release Debtor from the indenture if the defeasance provisions were met). As a result, provided the defeasance provisions are met, Debtor would be deemed legally released. Because determining whether this release has occurred is a matter of law, a legal (defeasance) opinion is customarily issued in connection with refunding transactions that, among other things, addresses the issue about whether the debtor has been legally released.

If the Year 1 bond indenture had not included a defeasance clause and bondholder agreement to the release was not otherwise obtained, transferring the assets to the Trust would have represented an in-substance defeasance instead of a legal defeasance. In-substance defeasance transactions do not result in extinguishment accounting for the liability as explained in paragraphs 405-20-55-3 to 55-4.

As explained in Example 4.10.20, if Debtor remained secondarily liable and the other criteria for derecognition of the Year 1 debt were met, Debtor would apply the guidance in paragraph 405-20-40-2 and recognize a guarantee obligation initially measured at fair value. Consideration should also be given to the need for an additional obligation for the contingent aspect of the guarantee (i.e. the current expected credit loss), accounted for under Topic 326.

Evaluating conditions for derecognizing the transferred assets

We believe the guidance in paragraphs 860-10-40-4 to 40-5 should be applied to transfers of either cash or financial assets from Debtor (the transferor) to the unconsolidated irrevocable trust (the transferee). Paragraph 860-10-40-5 requires three conditions to be met for transferred assets to be derecognized, including that the transferred assets must have been isolated from the transferor (Debtor).

Paragraphs 860-10-40-7 to 40-14 and the guidance beginning at paragraph 860-10-55-18 indicate that derecognition of transferred financial assets is appropriate only if reasonable evidence has been obtained to support an

assertion that the transferred financial assets have been isolated. Determining the extent of evidence needed to support such an assertion is a matter of judgment that depends on the facts and circumstances, including whether a legal opinion is needed to conclude that assets transferred to the unconsolidated irrevocable trust have been put presumptively beyond the reach of Debtor and its creditors, even in bankruptcy.

If Debtor determines that both the liability has been legally extinguished and it has surrendered control over the assets placed in the Trust, Debtor derecognizes the liability and transferred assets and recognizes a gain or loss on extinguishment of the debt and the assets in the financial statements.

See Subtopic 610-20 when accounting for the derecognition of nonfinancial assets transferred.

4.10.20 Extinguishments of convertible debt instruments



Excerpt from ASC 470-50

> Extinguishment of Convertible Debt

40-4 The extinguishment of convertible debt does not change the character of the security as between debt and equity at that time. Therefore, a difference between the cash acquisition price of the debt and its net carrying amount shall be recognized currently in income in the period of extinguishment as losses or gains.



Question 4.10.40

What is the accounting treatment for an extinguishment of a convertible debt instrument that has no proceeds allocated to the conversion feature?

Interpretive response: The difference between the cash acquisition price of the debt and its net carrying amount is recognized as a gain or loss on debt extinguishment.

When convertible debt is extinguished for cash or other assets, a debtor compares the acquisition price of the debt to the net carrying amount to determine if there is a gain or loss. When a debt instrument has matured and any discount has been fully accreted, the net carrying amount is equal to the acquisition price and no gain or loss exists.

However, if the instrument has not matured, there is typically a difference between the net carrying amount of the instrument and the acquisition price. This amount is recorded as an extinguishment gain or loss in the income statement.

**Example 4.10.40****Reacquisition of convertible bonds in the market**

On January 1, Year 4, Debtor issues \$10 million of 20-year notes (10,000 notes with a par value of \$1,000 per note) for par.

- Each note is convertible into 50 common shares of Debtor (i.e. \$20 conversion price).
- The convertible note is in the scope of the 'no proceeds allocated' model. The conversion option is not required to be bifurcated and accounted for as a derivative and it was issued for its par value (and therefore not at a substantial premium).
- The notes have a 2% coupon and cash interest payments are made annually on December 31.
- The noteholder may redeem the notes (i.e. put the notes back to Debtor) for par at any time after seven years. The put option does not require bifurcation as a derivative.
- Debtor incurs \$300,000 of debt issuance costs with third parties.

Debtor records the issuance of the notes and related debt issuance costs in the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	10,000,000	
Convertible notes payable		10,000,000
Convertible notes payable (debt issuance costs)	300,000	
Cash		300,000
<i>To recognize issuance of convertible notes and related issuance costs.</i>		

Debtor accretes the \$300,000 of debt issuance costs using the effective interest method over the seven-year period to the earliest put date. From January 1, Year 4 to December 31, Year 8, Debtor accretes \$210,000 of the debt issuance costs into interest expense.

On January 1, Year 9, Debtor repurchases 5,000 notes (50% of the outstanding notes) in the open market for \$7.75 million (\$1,550 per note). The unaccreted debt issuance costs allocable to the 5,000 notes reacquired are \$45,000 (\$90,000 total unaccreted cost × 50%). Transaction costs associated with the repurchase are insignificant.

The net carrying amount of the reacquired notes and loss on their extinguishment are as follows.

Par value of reacquired notes	\$5,000,000
Unaccreted third-party debt issuance costs	(45,000)
Net carrying amount of debt	4,955,000
Reacquisition price	7,750,000
Loss on debt extinguishment	\$(2,795,000)

Debtor records the extinguishment of the 5,000 notes it reacquired in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Convertible notes payable	5,000,000	
Loss on debt extinguishment	2,795,000	
Convertible notes payable (debt issuance costs)		45,000
Cash		7,750,000
<i>To recognize reacquisition of convertible notes.</i>		

Debtor continues to accrete the unaccreted debt issuance costs for the convertible notes that it did not reacquire using the effective interest method over the remaining two-year period until the earliest put date.



Question 4.10.50

What is the accounting treatment for an extinguishment of a convertible instrument with a bifurcated conversion feature?

Interpretive response: The convertible debt extinguishment accounting discussed in section 4.5.20 (when a convertible debt instrument is substantially modified) indicates that a difference between the cash acquisition price of the debt and its net carrying amount is recognized as a gain or loss on debt extinguishment. This accounting is applied even if the conversion option is separately accounted for as a derivative liability under Topic 815. In that circumstance, the carrying amount of the debt includes the extinguishment-date carrying amount (fair value) of the separated conversion option to measure the gain or loss on extinguishment.

Because the conversion option was bifurcated, it is no longer a consideration when accounting for the debt instrument. However, we believe both instruments should be derecognized to reflect the extinguishment, even when there is a legal conversion that results in an exchange for common shares.

Similarly, if convertible preferred shares with a conversion option that is separately accounted for as a derivative liability is redeemed for cash, the carrying amount of the preferred shares includes the redemption-date carrying amount (fair value) of the separated conversion option.



Question 4.10.60

What is the accounting treatment for an extinguishment of a convertible instrument with a bifurcated conversion feature that was subsequently reclassified to equity?



Excerpt from ASC 815-15

- > Option Is Extinguished Before Stated Maturity

40-4 If a convertible debt instrument with a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to the guidance in paragraph 815-15-35-4 is extinguished for cash (or other assets) before its stated maturity date, the entity shall do both of the following:

- The portion of the reacquisition price equal to the fair value of the conversion option at the date of the extinguishment shall be allocated to equity.
- The remaining reacquisition price shall be allocated to the extinguishment of the debt to determine the amount of gain or loss.

Interpretive response: When a conversion feature in convertible debt is bifurcated as a derivative liability but subsequently qualifies to be equity-classified, the fair value of the conversion feature at the date the criteria for equity classification are met is reclassified into equity. The debt host is unaffected and continues to be accounted for at amortized cost. [815-15-35-4]

If the instrument is extinguished for cash (or other assets) before its stated maturity date, the fair value of the consideration transferred to the holder is allocated between the equity component and the debt obligation as follows. [815-15-40-4]

Step A

Allocate a portion of the settlement consideration to the reacquisition of the equity component based on the fair value of the conversion option immediately before extinguishment and record that amount as a reduction of APIC.

Step B

Allocate the remaining settlement consideration to the extinguishment of the debt obligation. Any difference between (i) the consideration attributed to the debt obligation and (ii) the net carrying amount of the debt obligation at the settlement date (including any unaccreted discount and unaccreted debt issuance costs) is reported in earnings as a gain or loss on debt extinguishment.



Question 4.10.70

What is the accounting treatment for an extinguishment of a convertible instrument with bifurcated derivatives other than a conversion option?

Interpretive response: When other embedded features have been bifurcated as derivatives from the convertible instrument, judgment is required when determining the appropriate accounting treatment for the extinguishment. Generally, bifurcated derivatives are extinguished concurrently with the extinguished instrument, so we believe that the carrying amount of the bifurcated derivative should be included in the carrying amount of the instrument when calculating the gain or loss on extinguishment (or charge to retained earnings for preferred shares). This treatment is consistent with that noted for bifurcated conversion options.

Further, we believe this treatment is consistently applied when determining appropriate accounting for a modification or exchange of nonconvertible debt instruments with embedded derivatives that have been bifurcated and separately recorded.



Question 4.10.80

What is the accounting treatment for an extinguishment of a convertible debt instrument issued at a substantial premium?

Interpretive response: There is no specific guidance on how to account for an extinguishment of a convertible debt instrument with an equity component that was separately recorded because the instrument was issued at a substantial premium. We believe the fair value of the consideration transferred to the holder should be allocated between the equity component (substantial premium) and the debt obligation as follows.

Step 1

Allocate a portion of the settlement consideration to the equity component and record that amount as a reduction of APIC. We believe a rational allocation method should be applied that considers the economic facts and circumstances of the extinguishment transaction.

Step 2

Allocate the remaining settlement consideration to the extinguishment of the debt obligation. Any difference between (i) the consideration attributed to the debt obligation and (ii) the net carrying amount of the debt obligation at the settlement date (including any unaccreted discount and unaccreted debt issuance costs) is reported in earnings as a gain or loss on debt extinguishment.

4.10.30 Situations that do not result in debt extinguishment



Excerpt from ASC 470-50

- > Situations that Do Not Result in an Extinguishment of Debt

55-9 The following situations do not result in an extinguishment and would not result in gain or loss recognition under either paragraph 405-20-40-1 or this Subtopic:

- a. An announcement of intent by the debtor to call a debt instrument at the first call date
- b. **In-substance defeasance**
- c. An agreement with a creditor that a debt instrument issued by the debtor and held by a different party will be redeemed.



Excerpt from ASC 405-20

- • > In-Substance Defeasance Transactions

55-3 In an in-substance defeasance transaction, a debtor transfers essentially risk-free assets to an irrevocable defeasance trust and the cash flows from those assets approximate the scheduled interest and principal payments of the debt being extinguished.

55-4 An in-substance defeasance transaction does not meet the derecognition criteria in either Section 405-20-40 for the liability or in Section 860-10-40 for the asset. The transaction does not meet the criteria because of the following:

- a. The debtor is not released from the debt by putting assets in the trust; if the assets in the trust prove insufficient, for example, because a default by the debtor accelerates its debt, the debtor must make up the difference.
- b. The lender is not limited to the cash flows from the assets in trust.
- c. The lender does not have the ability to dispose of the assets at will or to terminate the trust.
- d. If the assets in the trust exceed what is necessary to meet scheduled principal and interest payments, the transferor can remove the assets.
- e. Subparagraph superseded by Accounting Standards Update No. 2012-04.
- f. The debtor does not surrender control of the benefits of the assets because those assets are still being used for the debtor's benefit, to extinguish its debt, and because no asset can be an asset of more than one entity, those benefits must still be the debtor's assets.

Subtopic 470-50 lists three scenarios to redeem a debt that do not result in debt extinguishment: [\[470-50-55-9\]](#)

- announcement of intent to call a debt instrument at the first call date
- in-substance defeasance
- agreement with a creditor that a debt instrument held by a third party will be redeemed.



Example 4.10.60

Announcement of intent to repurchase debt that is subject to a prepayment penalty

On March 15, Debtor gave a 30-day notice to its bondholders that it will repurchase \$25 million of its bonds on April 15. The Bond Indenture Agreement requires Debtor to pay a \$3 million prepayment penalty if it repays the bonds before their maturity date.

Debtor records the prepayment penalty when it redeems the bonds. Its notification to its bondholders of its intent to repurchase \$25 million of debt does not, by itself, result in the recognition of a gain or loss. Paragraph 470-50-40-2 requires any gain or loss from an extinguishment of debt to be recognized in the period of extinguishment. Paragraph 405-20-40-1 specifies that a liability is extinguished only when (a) the debtor pays the creditor and is relieved of its obligation for the liability or (b) the debtor is legally released as the primary obligor under the liability. Announcing the debtor's intent to extinguish a liability in the future does not meet either of those conditions for extinguishment. Further, paragraph 470-50-55-9(a) specifies that an announcement of intent by a debtor to call a debt instrument at the first call date does not result in an extinguishment and would not result in gain or loss recognition.

Debtor discloses in its financial statements that it has notified its bondholders that it will repurchase \$25 million of debt and the extinguishment's likely accounting effect. Further, Debtor reviews the classification of the debt instruments (long-term versus current liabilities) on its balance sheet based on its intent to redeem the bonds. Before extinguishment, Debtor may continue to record interest expense based on the original terms of the debt instrument and continue to accrete/amortize related discounts, premiums, and debt issuance costs over the amortization period that it used before it announced its intent to call the debt.

Because there is no specific guidance on updating the estimated life of a debt instrument, we understand some entities make an accounting policy election at inception of a debt instrument to continually update their estimates with respect to the life of the debt instrument with any changes accounted for prospectively. As long as such a policy is applied consistently for all debt instruments, we believe such a policy would require Debtor to continuously re-estimate the life of the instrument, and record interest expense and accrete/amortize related discounts, premiums, and debt issuance costs based upon its reassessed best estimate of the life of the instrument. In this example, if Debtor internally decided on February 1 that it would call its debt on April 15, Debtor would recognize all future interest expense and accrete/amortize all remaining related discounts, premiums, and debt issuance costs from the day it decided to repay the debt (February 1) through the new payment date of April 15 (however, Debtor would not include the prepayment penalty in its accounting until the debt is extinguished).



Question 4.10.110

Is there a difference in applying derecognition accounting for an in-substance defeasance compared to a legal defeasance?

Interpretive response: Yes. In a legal defeasance, the debtor is legally released from its obligation by the creditor, which would meet one of the criteria for extinguishment. Whether the debtor has been released from its obligation by the creditor is a matter of law. [405-20-40-1(b), 55-9]

With an in-substance defeasance, the debtor transfers assets into an irrevocable trust to repay the debt. As the debtor does not surrender control of the benefits of the assets placed in the trust the debtor is not legally released from the obligation, and therefore the liability is not extinguished. Whether the debtor has been legally released in a defeasance is a matter of law, which in some cases may require a legal opinion.



Question 4.10.120

How is a secondary offering or related exchange that enables a debtor to exchange unregistered debt securities for registered debt securities accounted for under Subtopic 470-50?

Interpretive response: Debt agreements and related contracts associated with a private placement of debt securities may require the issuer to use its best efforts to register the securities with the SEC within a specified period. Frequently, there are contingent interest payments or other penalties that become due if the issuer is unable to register the debt securities or maintain registration for a specified period. Registration of the debt securities may be accomplished through a secondary offering that enables investors to exchange the old, unregistered debt securities for new registered debt securities, but does not provide the issuer with additional proceeds. The issuer will incur third-party transaction costs (e.g. legal fees) associated with the process of registering the debt securities.

We believe that a secondary offering or related exchange does not represent a debt modification or exchange subject to Subtopic 470-50 if it enables investors to exchange unregistered debt securities for registered debt securities but does not modify the terms of the debt instrument itself. Further, we believe the appropriate accounting treatment for third-party transaction costs depends on whether the original private placement agreements required the issuer to register (or to use its best efforts to register) the debt securities, as discussed in the following paragraphs.

If registration is required per the original agreement:

If the terms of the original private placement agreements require the issuer to register the debt securities (or to use its best efforts to register the debt securities), we believe that third-party transaction costs associated with the subsequent registration should be accounted for as an issuance cost of the

original private placement. Therefore, we believe that the issuer should include its estimate of the future registration costs in its effective interest rate calculations from the date of the original private placement. Any difference between the amount or timing of the registration costs ultimately incurred and the initial estimates should be recognized prospectively in the effective interest rate as a change in estimate. For balance sheet presentation purposes, we believe that either of the following approaches are acceptable alternatives for the future registration costs.

Approach 1: Accrue the registration costs when the debt securities are issued

Accrue a liability at the time of the original private placement based on the estimated future registration costs and increase the debt issuance costs on the debt issued by increasing the capitalized debt issuance costs related to that offering.

Approach 2: Record no amount on the balance sheet at the time of the original debt offering, but include the registration costs in applying the effective interest method

Record no amounts on the balance sheet at the time of the original private placement but include the estimated future registration costs in the issuer's application of the effective interest method from the date of the original offering. This approach will result in the accrual of a liability for the estimated future registration costs as the incremental interest costs are recognized. When the registration costs are incurred, the excess of those costs over the original estimated registration costs will be capitalized as debt issuance costs.

Both of these approaches should result in the same balance sheet amounts after the registration costs are incurred.

If it becomes probable that the issuer will incur an obligation to make payments (including contingent interest payments) as a penalty for not registering the debt securities or maintaining registration, the issuer recognizes a liability using the guidance in Subtopic 450-20 (loss contingencies) if it can reasonably estimate the payment amount (or a range of amounts). The issuer records the liability as a charge to earnings unless the contingent payment is probable and can be reasonably estimated at the original issuance date, in which case the liability is included in the allocation of proceeds from the related financing transaction. [825-20-30-4]

If registration is not required per the original agreement:

If the terms of the original private placement agreement do not require the issuer to register the debt securities (and do not require the issuer to use its best efforts to register the debt securities), then we believe that registration costs should be expensed as incurred because the issuer receives no proceeds in the secondary offering.



Example 4.10.70

Exchange of unregistered debt securities for registered debt securities

Debtor issues fixed-rate debt securities in a private placement to qualified institutional buyers in December Year 5. Under the terms of the debt agreements, Debtor is contractually obligated to use its best efforts to register the debt securities within 180 days of issuance.

On May 1, Year 6, Debtor files a registration statement to exchange the old (unregistered) notes for new (registered) notes. The registration statement is effective on July 15, Year 6.

In connection with the registration process and the exchange, there are no modifications to the terms of the notes (i.e. the principal amount, maturity date, interest rate, and all other terms remain the same). Debtor incurs legal fees and other miscellaneous costs to third parties to register the new notes. It neither paid nor received cash or other consideration to/from the note holders when it executed the exchange of unregistered notes for registered notes. Filing the registration statement to exchange the old notes for new notes was based on the original terms of the debt instrument. There were no modifications to the debt instrument. Therefore, the exchange is not in the scope of Subtopic 470-50.

We believe Debtor should include its estimate of the future registration costs in its effective interest rate calculations from the date of the original private placement, with any difference between the amount or timing of the registration costs ultimately incurred and the initial estimates recognized prospectively in the effective interest rate as a change in estimate (see Question 4.10.120). Except for the effects of changes in estimates, the effective interest rate should be the same before and after the exchange of the old notes for the new notes because the exchange followed the original terms of the debt instrument. For balance sheet presentation purposes, we believe either presentation approach discussed in Question 4.5.60 is an acceptable alternative for the future registration costs.

Approach 1: Accrue the registration costs when the debt securities are issued

Under this approach, Debtor accrues a liability at the time of the original private placement based on the estimated future registration costs and increases the capitalized debt issuance costs related to the offering. The difference between the actual costs and the estimated amount should generally be accounted for as a change in estimate (which would be recognized prospectively through an adjustment to the effective interest rate).

Approach 2: Record no amount on the balance sheet at the time of the original debt offering, but include the registration costs in applying the effective interest method

Under this approach, Debtor computes and recognizes interest expense from the date the debt is issued, including amortization of the issuance costs, based on the expected effective interest rate for the debt (i.e. including the costs Debtor expects to incur to effect the exchange of the old notes for the new

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notes). This approach results in the accrual of a liability for the estimated future registration costs over time as the incremental interest costs are recognized.

Once Debtor incurs the registration costs, it capitalizes the excess of the costs over the carrying amount of the liability as debt issuance costs. However, there should be no change to the effective interest expense on the debt after recording the costs, if the amount of the actual costs to effect the exchange of the notes equals the amount originally estimated. Consistent with Approach 1, the difference between the actual costs and the estimated amount generally is accounted for as a change in estimate, which would be recognized prospectively through an adjustment to the effective interest rate.

5. Equity

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5.1 How the standard works

Equity represents an owner's interest in an entity and generally comprises amounts contributed by the owners plus earnings retained by the entity. There are different components of equity, as follows.

Common shares Preferred shares APIC	Retained earnings	Treasury shares	AOCI	Noncontrolling interests
Amounts raised when an entity issues shares or other equity-classified instruments	Accumulated earnings of an entity in excess of its distribution to its shareholders	Common shares repurchased from an entity's shareholders	Certain transactions and events from nonowner sources	Portion of equity in a subsidiary not attributable, directly or indirectly, to a parent

How an equity transaction affects each component depends on the nature of the transaction. For example, proceeds from the initial issuance of common shares increase common shares (and potentially APIC) while proceeds from reissuing treasury shares decrease treasury shares (and potentially APIC and/or retained earnings).

An entity excludes its equity transactions (e.g. issuing shares or paying dividends) when determining net earnings and comprehensive income. An entity's accumulation of earnings is included in retained earnings.

Each type and class of equity shares can have different levels of rights and risks. Common shareholders typically have voting rights and may benefit economically through dividends and capital appreciation. In contrast, preferred shareholders and creditors typically have preferential rights over common shareholders, including priority in the event of bankruptcy or liquidation.

5.2 Scope of Topic 505

5.2.10 Overview



Excerpt from ASC 505-10

05-2 The Overall Subtopic addresses financial accounting and reporting for equity-related matters not specifically addressed in the other Subtopics of the Equity Topic or other Topics that also address equity matters.

05-3 Equity, sometimes referred to as net assets, is the residual interest in the assets of an entity that remains after deducting its liabilities. The Subtopics of the Equity Topic provide guidance on several specific elements of transactions, accounts and financial instruments that are classified as components of equity as well as overall general guidance related to equity. Issues that relate to whether a specific financial instrument shall be classified as equity or outside of the equity classification are addressed in Topic 480 as well as other Topics (such as Topic 815 on derivatives and hedging) that address these classification matters.

05-4 Other Topics, including industry-specific Topics, also contain guidance related to specific equity matters associated with those Topics. Equity guidance in those Topics is intended to be incremental to the guidance otherwise established in this Topic.

> Convertible Preferred Stock

05-5 Entities may issue convertible preferred stock that may be convertible into common stock at the lower of a conversion rate fixed at time of issuance and a fixed discount to the market price of the common stock at the date of conversion.

05-6 Certain convertible preferred stock may have a contingently adjustable conversion ratio. Examples of a conversion price that is variable based on future events are the following:

- a. A liquidation or a change in control of an entity
- b. A subsequent round of financing at a price lower than the **convertible security's** original conversion price
- c. An initial public offering at a share price lower than an agreed-upon amount.

05-7 Certain convertible preferred stock may become convertible only upon the occurrence of a future event outside the control of the holder.

> Entities

15-1 The guidance in this Subtopic applies to all entities, unless more specific guidance is provided in other Topics.

> Instruments

15-2 The guidance in this Subtopic applies to all of the following instruments and activities:

- a. Transactions in an entity's own common stock
- b. Receivables related to the issuance of equity interests and the appropriation of retained earnings...
- d. Convertible preferred stock, unless the guidance in other Subtopics (such as Subtopic 470-20 on debt with conversion and other options or 480-10 on distinguishing liabilities from equity) requires that convertible preferred stock be classified as a liability. The relevant guidance in this Subtopic shall be considered after an issuer's determination under Subtopic 815-15 on embedded derivatives of whether an embedded conversion option or other embedded feature in convertible preferred stock should be accounted for separately as a derivative instrument (see 815-15-55-76B). The guidance in this Subtopic does not apply to convertible preferred stock that is issued as awards to a grantee in exchange for goods or services received (or to be received) that are within the scope of Topic 718 on stock compensation unless the instrument is modified in accordance with and no longer subject to the guidance in that Topic.

25-2 All of the following shall be excluded from the determination of net income or the results of operations under all circumstances:

- a. Adjustments or charges or credits resulting from transactions in the entity's own capital stock
- b. Transfers to and from accounts properly designated as appropriated retained earnings (see paragraph 505-10-45-3 for what is meant by properly designated as appropriated retained earnings)
- c. Adjustments made pursuant to a quasi-reorganization (see Subtopic 852-20 for information concerning quasi-reorganizations).

This chapter is focused primarily on accounting for equity transactions that are in the scope of Topic 505, including issuing and repurchasing shares, making distributions and changing an entity's capital structure. It includes accounting for equity-classified convertible preferred stock.

There are several aspects of accounting for equity transactions that are addressed in other Topics, some of which are addressed in other chapters of this Handbook or in other KPMG Handbooks, as summarized in the following table.

Accounting issue	Addressed in
Distinguishing liabilities from equity	Chapter 6
Classification of redeemable equity-classified instruments	Chapter 7
Convertible instruments	Chapter 10
Classification of equity-linked features in hybrid instruments	Chapter 8
Registration payment arrangements	Subtopic 825-20
Consolidation, including treatment of shares of a parent held by its subsidiary or accounting for the purchase (or early extinguishment) of a wholly owned subsidiary's mandatorily redeemable preferred shares	Topic 810 See also KPMG Handbook, Consolidation

Accounting issue	Addressed in
Nonmonetary transactions – other than stock dividends and splits that are accounted for under Subtopic 505-20 (see section 5.7)	Topic 845
<p>Incremental guidance for equity transactions included in other Topics. For example, this chapter does not address incremental guidance for transactions in the scope of the following Topics:</p> <ul style="list-style-type: none"> — Topic 606 (revenue) on equity instruments granted in conjunction with selling goods or services to customers as part of a contract — Topic 718 (stock compensation) on share-based payment transactions with employees and non-employees 	<ul style="list-style-type: none"> — KPMG Handbook, Revenue recognition — KPMG Handbook, Share-based payment

This chapter focuses on the corporate form of ownership. Although many concepts are similar, an entity’s legal structure (e.g. a partnership, corporation) significantly influences accounting for equity.

5.2.20 Components of equity

The equity section of the balance sheet can contain several components. Understanding each component’s purpose is essential to understanding how different equity transactions are accounted for. This section defines each component of equity.

Common shares, preferred shares and APIC

Paid-in capital comprises capital raised by issuing equity instruments, including one or more classes of common shares or preferred shares, as summarized in the following table.

Instrument	Accounting
Common shares	<ul style="list-style-type: none"> — Common shares with a par or stated amount. The common share account is credited for that par or stated amount, with the remaining proceeds credited to APIC. — Common shares with no par or stated amount. In our experience, the common share account is credited for the entire proceeds. Alternatively, an entity may credit APIC for the entire proceeds (see section 5.3.20).
Preferred shares	<ul style="list-style-type: none"> — In our experience, the preferred share account is typically credited for the entire proceeds. — Alternatively, if preferred shares are issued for an amount in excess of par, an entity may record the par value to the preferred shares account with the remaining proceeds credited to APIC. This approach is appropriate only if it does not conflict with other accounting requirements for the preferred shares, such as measurement requirements

Instrument	Accounting
	for preferred shares classified as temporary equity (see sections 7.4.40 – 7.4.50).
Other equity-classified instruments	<p>APIC is recognized for other equity-classified instruments, which may include:</p> <ul style="list-style-type: none"> — forward contracts to issue an entity’s own equity shares; — warrants that allow the holder to purchase equity shares for a specified price (the exercise or strike price) during a specified period. <p>However, these instruments do not affect APIC if they are classified as liabilities under Topic 480 (see chapter 6) or otherwise do not meet the conditions for equity classification in Subtopic 815-40 (see chapter 8).</p>

As indicated in the table, APIC is recognized for amounts received in excess of a share’s par or stated amount and for other equity-classified instruments. It is also impacted by certain other transactions (see section 5.5.20). While APIC may be used to record amounts related to multiple instruments and transactions, it is important to separately maintain information about the amounts in APIC because that information may be needed when recording future transactions – e.g. when retiring treasury shares (see section 5.8.40) or extinguishing callable preferred shares (see Question 5.4.40).

Treasury shares

Treasury shares are an entity’s own issued common shares that the entity repurchases.

Retained earnings

Retained earnings are an entity’s accumulated earnings in excess of distributions to shareholders.

Accumulated other comprehensive income

AOCI is used to record certain transactions and events from nonowner sources that are recorded as OCI but are excluded from net income. The following table summarizes the items included in AOCI.

Accounting issue	Addressed in
Unrealized gains or losses on available-for-sale debt securities	Topic 320 See also KPMG Handbook, Investments
Certain gains or losses related to defined benefit plans	Topic 715
Certain gains or losses resulting from hedging activities	Topic 815 See also KPMG Handbook, Derivatives and hedging
Adjustments for translating an entity’s financial statements from a functional currency that is a foreign currency to the reporting currency (cumulative translation adjustments)	Topic 830 See also KPMG Handbook, Foreign currency

Accounting issue	Addressed in
Changes in the fair value of financial liabilities attributable to instrument-specific credit risk when those liabilities are measured using the 'fair value option'	Topic 825

Noncontrolling interests

NCI represents the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. An NCI is sometimes called a minority interest.

5.3 Common shares

5.3.10 Overview

A common share represents an ownership interest in a corporation. In the event of a bankruptcy or liquidation, common shareholders generally have lower preference than preferred shareholders, bondholders and other debt holders.

The following table identifies typical rights of common shareholders.

Rights	Description
Election	The ability to elect the board of directors
Voting	The ability to vote on matters presented in the proxy statement – e.g. election of the independent auditor
Residual interest	A residual interest in the corporation – e.g. net earnings of the entity after all other claims have been satisfied
Dividends	The right to receive dividends approved by the board of directors

Par or stated value

Common shares may be issued with or without a par or stated value. Par value is the minimum amount a shareholder must pay for the share to be considered fully paid when issued. Laws in many US states provide that shareholders may be liable to the entity's creditors on dissolution if common shares were issued below par value. Therefore, entities generally issue common shares with a nominal par or stated value (e.g. \$0.01 per share) to the extent permitted by applicable state law. If permitted, an entity may issue common shares with no par value, in which case it may establish a stated value per share.

Types of common share issuances

Common shares are issued for a variety of reasons, with or without other financial instruments, and the issuance proceeds are not always in the form of cash. The following table explains the primary accounting consideration for many common types of issuance transactions.

Types of issuance transactions	Primary accounting consideration
Common shares issued at fair value (section 5.3.20)	Unless there is evidence to the contrary, proceeds from the issuance of shares solely

Types of issuance transactions	Primary accounting consideration
	for cash are assumed to equal the fair value of the shares issued.
Common shares issued with other detachable or freestanding securities (e.g. warrants) (section 5.3.30)	Proceeds from shares issued with other securities are allocated between the shares and the other securities based on their relative fair values, unless one or more of the securities are measured at fair value at each reporting date.
Common shares issued for an off-market price (section 5.3.40)	If the proceeds received from the sale of the shares do not equal the fair value of the shares, the transaction may involve a stated or unstated right, privilege or obligation that requires separate accounting.
Common shares issued for a note receivable (section 5.3.50)	If a note is received in exchange for a share, the note is typically reported as contra-equity. In very limited circumstances, such a note may be reported as an asset.
Common shares issued to effect a business combination (section 5.3.60)	The shares are recorded at fair value.
Over-allotment (Greenshoe) provisions (section 5.3.70)	The accounting for a greenshoe provision depends on whether it is: <ul style="list-style-type: none"> — freestanding or embedded; — issued in connection with debt or equity shares; and — required to be subsequently measured at fair value with changes in earnings.

Certain features included in a common share can result in the share being classified as a liability or as temporary equity (if applicable) or may require separate accounting. Such features are most frequently associated with preferred shares (such as redemption or conversion options) but may also be included in common shares. Section 5.4.20 provides a high-level summary of considerations when accounting for preferred shares, and those same accounting considerations apply to common shares.

5.3.20 Common shares issued for fair value

An entity can issue shares in exchange for cash, property, goods, services or a combination of these items. Generally, an entity records common shares at fair value when issued. When common shares are issued solely for cash, the cash received is presumed to equal the fair value of the issued shares, absent evidence to the contrary.

The issuance of common shares at fair value is recorded when issued as follows. [\[505-10-25-2\(a\)\]](#)

	Debit	Credit
Common shares with a par or stated value	Cash received	Common shares for number of shares issued × par or stated value per share APIC for remaining proceeds
Common shares with no par or stated value	Cash received or fair value of consideration	Either of the following is acceptable as an accounting policy consistently applied: <ul style="list-style-type: none"> — common shares for entire proceeds – in our experience, most entities apply this policy; or — APIC for entire proceeds.



Example 5.3.10 Common shares issued for cash

Issuer issues 1,000 common shares for \$12 per share.

Scenario 1: Shares have \$1 par value

Issuer records the following journal entry.

	Debit	Credit
Cash	12,000	
Common shares – par value		1,000
APIC ¹		11,000
<i>To recognize issuance of common shares with \$1 par value.</i>		
Note:		
1. Proceeds from issuance (\$12,000) – Par value (\$1,000).		

The same accounting results if common shares have a stated value instead of a par value.

Scenario 2: Shares have no par or stated value

Issuer has an accounting policy to credit all amounts received when the shares are originally issued to the common shares account. Issuer records the following journal entry.

	Debit	Credit
Cash	12,000	
Common shares		12,000
<i>To recognize issuance of common shares with no par or stated value.</i>		

5.3.30 Common shares issued with other detachable or freestanding securities

When common shares are issued with other detachable or freestanding securities, the proceeds from the issuance are allocated to the common shares and the other securities.



Question 5.3.10

How are proceeds received for common shares issued with other detachable or freestanding securities allocated?

Interpretive response: The method of allocation depends on whether the other securities are required to be measured at fair value at each reporting date.

<p>Other securities required to be measured at fair value</p>	<p>An entity records the other securities at fair value and allocates the remainder of the proceeds to the common shares. An example of such an 'other' security is a warrant that does not meet Subtopic 815-40's requirements for equity classification (see chapter 8).</p>
<p>Other securities not required to be measured at fair value</p>	<p>We believe an entity should allocate the proceeds to the shares and other securities on a relative fair value basis. An example of such an 'other' security is a warrant that meets Subtopic 815-40's requirements for equity classification. [470-20-25-2]</p>



Example 5.3.20

Common shares and debt issued for cash

On January 1, Year 1, Issuer enters into a financing arrangement with Holder. Issuer receives proceeds of \$1.1 million from Holder in exchange for the following:

- 200,000 **common shares** with a \$1 par value per share. The fair value of the common shares on that date is \$2 per share, resulting in a total fair value of \$400,000. The shares are classified as equity.
- \$1 million **note** bearing interest at 10% that matures on December 31, Year 1. The fair value of the note is \$800,000. The note is accounted for as a liability on an amortized cost basis.

Allocation

Instrument	Fair value	Relative fair value % ¹	Allocated proceeds ²
Common shares	\$ 400,000	33%	\$ 366,667
Note payable	800,000	67%	733,333
Total	\$1,200,000	100%	\$1,100,000

Notes:

1. Fair value of instrument ÷ Total fair value (\$1.2 million).
2. Relative fair value % × Total proceeds (\$1.1 million).

Journal entry

Issuer records the following journal entry.

	Debit	Credit
Cash	1,100,000	
Notes payable – discount ¹	266,667	
Common shares – par value ²		200,000
Notes payable		1,000,000
APIC ³		166,667
<i>To recognize issuance of common shares and debt issued together for cash.</i>		

Notes:

1. Par value of note (\$1 million) – Proceeds allocated to note (\$733,333).
2. 200,000 common shares issued × \$1 per share.
3. Proceeds allocated to the common shares (\$366,667) – Par value of those shares (\$200,000).

5.3.40 Common shares issued at an off-market price

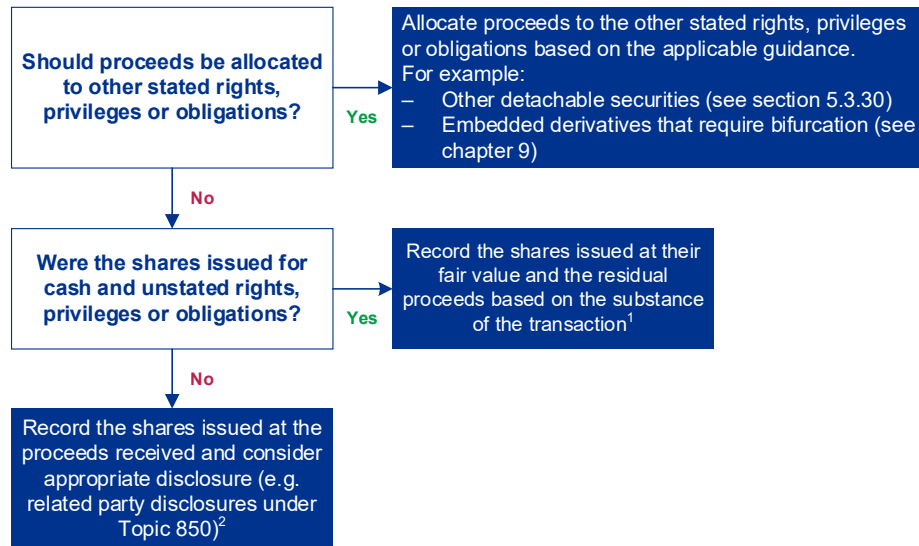
If the proceeds received from the issuance of common shares do not equal the fair value of the shares, the entity determines whether the transaction involves a stated or unstated right, privilege or obligation requiring separate accounting. If a right, privilege or obligation exists, the proceeds from the issuance need to be allocated between it and the common shares.



Question 5.3.20

How are proceeds received for common shares issued at an off-market price allocated?

Interpretive response: We believe an entity should allocate proceeds as shown in the following decision tree. [505-30-25-3, 835-30-25-6]



Notes:

1. In certain situations, with private companies, the fair value of the unstated right, privilege or obligation may have a more objectively determinable fair value than the fair value of its shares. In this situation, the value allocated to the common shares is the residual amount of the consideration received.
2. We believe these situations are rare.

5.3.50 Common shares issued for a note receivable



Excerpt from ASC 505-10

> Receivables for Issuance of Equity

45-2 An entity may receive a note, rather than cash, as a contribution to its equity. The transaction may be a sale of capital stock or a contribution to paid-in capital. Reporting the note as an asset is generally not appropriate, except in very limited circumstances in which there is substantial evidence of ability and intent to pay within a reasonably short period of time, for example, as discussed for public entities in paragraph 210-10-S99-1 (paragraphs 27 through 29), which requires a deduction of the receivable from equity. However, such notes may be recorded as an asset if collected in cash before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25).

A note received in exchange for issuing common shares is generally presented as contra-equity. However, the note is presented as an asset if: [\[505-10-45-2\]](#)

- there is substantial evidence that the investor intends and is able to pay the note in full within a reasonably short period of time; or
- the issuer has collected cash before the financial statements are issued or are available to be issued.



Question 5.3.30

Must an SEC registrant present a note receivable received for equity shares as contra-equity?



Excerpt from SAB Topic 4.E

Receivables from Sale of Stock

Facts: Capital stock is sometimes issued to officers or other employees before the cash payment is received.

Question: How should the receivables from the officers or other employees be presented in the balance sheet?

Interpretive Response: The amount recorded as a receivable should be presented in the balance sheet as a deduction from stockholders' equity. This is generally consistent with Rule 5-02.30 of Regulation S-X which states that accounts or notes receivable arising from transactions involving the registrant's capital stock should be presented as deductions from stockholders' equity and not as assets.

It should be noted generally that all amounts receivable from officers and directors resulting from sales of stock or from other transactions (other than expense advances or sales on normal trade terms) should be separately stated in the balance sheet irrespective of whether such amounts may be shown as assets or are required to be reported as deductions from stockholders' equity.

The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to the publication of the financial statements and the payment date is stated in a note to the financial statements. However, the staff would consider the subsequent return of such cash payment to the officer or director to be part of a scheme or plan to evade the registration or reporting requirements of the securities laws.

Interpretive response: Yes, unless the note receivable is paid before the financial statements are issued. [\[SAB Topic 4.E\]](#)

An SEC registrant may not present the note receivable as an asset even if there is substantial evidence that the investor intends and is able to pay the note in full within a reasonably short period of time, but the note has not been paid before the financial statements are issued. Although the FASB permits such a

presentation in such circumstances, SEC guidance does not. [SAB Topic 4.E, 505-10-45-2]



Question 5.3.40

Must a corporate general partner present notes receivable from its parent or another affiliate as contra-equity?



Excerpt from SAB Topic 4.G

Notes and Other Receivables from Affiliates

Facts: The balance sheet of a corporate general partner is often presented in a registration statement. Frequently, the balance sheet of the general partner discloses that it holds notes or other receivables from a parent or another affiliate. Often the notes or other receivables were created in order to meet the "substantial assets" test which the Internal Revenue Service utilizes in applying its "Safe Harbor" doctrine in the classification of organizations for income tax purposes.

Question: How should such notes and other receivables be reported in the balance sheet of the general partner?

Interpretive Response: While these notes and other receivables evidencing a promise to contribute capital are often legally enforceable, they seldom are actually paid. In substance, these receivables are equivalent to unpaid subscriptions receivable for capital shares which Rule 5-02.30 of Regulation S-X requires to be deducted from the dollar amount of capital shares subscribed.

The balance sheet display of these or similar items is not determined by the quality or actual value of the receivable or other asset "contributed" to the capital of the affiliated general partner, but rather by the relationship of the parties and the control inherent in that relationship. Accordingly, in these situations, the receivable must be treated as a deduction from stockholders' equity in the balance sheet of the corporate general partner.

Interpretive response: Yes. Although notes and other receivables from a parent or another affiliate may be legally enforceable, they represent unpaid share subscriptions and are presented as contra-equity (see Question 5.3.50). [SAB Topic 4.G]



Question 5.3.50

How is a share subscription accounted for?

Background: A share subscription is an agreement between an investor and an entity that allows the investor to buy shares from the entity at a future date or

over a period of time. If the investor does not pay the full subscription proceeds up-front, the shortfall is considered a note receivable and therefore is generally presented as contra-equity.

Interpretive response: Under SEC guidance, the accounting for a share subscription that is not required to be accounted for as a derivative depends on when the investor pays the full amount of the proceeds. Any unpaid amount is treated the same as the issuance of shares for a note receivable. [S-X Rule 5-02.30, SAB Topic 4.E, SAB Topic 4.G]

Common shares are issued only when the investor pays in full	Record any partial payment in APIC until the full amount is paid and the shares are issued. Otherwise, there is no accounting until the shares are issued. At that time, the shares issued are recorded based on the guidance for share issuances in section 5.3.
Common shares are issued before the investor pays in full	Record common shares and APIC with a note receivable recognized for the unpaid portion. The note receivable is generally presented as a reduction of shareholders' equity (i.e. a contra-equity account) instead of as an asset, unless it meets certain conditions, as discussed previously in this section.

Any amounts that are refundable are classified as temporary equity by SEC registrants (and other entities that elect to follow similar accounting guidance). See chapter 7.

See also section 6.3 of KPMG Handbook, [Earnings per share](#), for discussion on the EPS treatment of partially subscribed shares.



Example 5.3.30

Common shares issued for note receivable

Issuer issues 1,000 common shares with a \$1 par value per share to Holder in exchange for a \$12,000 note receivable. Holder does not intend to pay within a short period of time. As a result, Issuer characterizes the note receivable as contra-equity instead of as an asset.

Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Note receivable (presented as contra-equity)	12,000	
Common shares – par value ¹		1,000
APIC ²		11,000
<i>To recognize issuance of common shares.</i>		
Notes:		
1. 1,000 shares issued × \$1 par value.		
2. Proceeds from issuance (\$12,000) – Par value of shares issued (\$1,000).		

Issuer's total equity is not affected when the shares are issued because no consideration was received by Issuer.



Question 5.3.60

Does an entity recognize nonrefundable amounts received as income if an investor defaults on a share subscription?

Interpretive response: No. If an investor defaults on a subscription receivable and the subscription agreement allows the entity to keep previous payments toward the subscription, the entity continues to report the payments received as APIC. Those amounts received relate to capital transactions and are never reclassified to earnings. [TPA 4110.011]

5.3.60 Common shares issued to affect a business combination

Shares issued by an acquirer to affect a business combination are recorded at fair value as of the acquisition date. [805-30-30-7]



Question 5.3.70

How is the fair value of equity shares determined when the shares are issued as consideration to affect a business combination?

Interpretive response: The fair value of such equity shares is measured under Topic 820, except for replacement share-based payment awards. Whenever available, the quoted price in an active market is used to measure the fair value of such equity securities. If a quoted price in an active market is not available, other methods or techniques (e.g. income approach) are used to determine their fair value. [805-30-30-7]

See section 6 of KPMG Handbook, [Business combinations](#), for further discussion.

5.3.70 Overallotment (greenshoe) provisions



Question 5.3.80

What is a greenshoe provision?

Interpretive response: Public debt and equity securities offerings have historically provided for the issuance of securities in addition to those initially offered if investor demand exceeds the expected amount. These overallotment provisions are known as greenshoe provisions. The term 'greenshoe provisions' comes from the Green Shoe Manufacturing Company, which was the first company to include this type of provision in a public offering.

Greenshoe provisions allow the underwriter to fill orders in excess of the planned offering and permits the issuer to issue more debt or equity securities without the time, expense and effort of an additional filing.

For example, an underwriter may anticipate issuing \$250 million worth of securities, but discover at the issuance date that there is additional demand from investors for the securities. The greenshoe provision enables the underwriter to sell additional securities at issuance. In effect, the issuer has written a call option on the underlying securities to the underwriters, usually with a fixed price equal to the original issuance price. The provisions may be considered valuable if the market price of the debt or equity securities is above the fixed exercise price on the greenshoe provision. This allows the underwriter to exercise the greenshoe option and immediately resell the securities at the higher market price.



Question 5.3.90

How does an entity account for a greenshoe provision?

Interpretive response: It depends. Determining the appropriate accounting for a greenshoe provision requires analysis of several factors. The first factor is to determine whether the greenshoe provision is a freestanding instrument. The remaining factors depend on whether the greenshoe provision is for a debt or equity security.

Determine whether greenshoe provision is freestanding

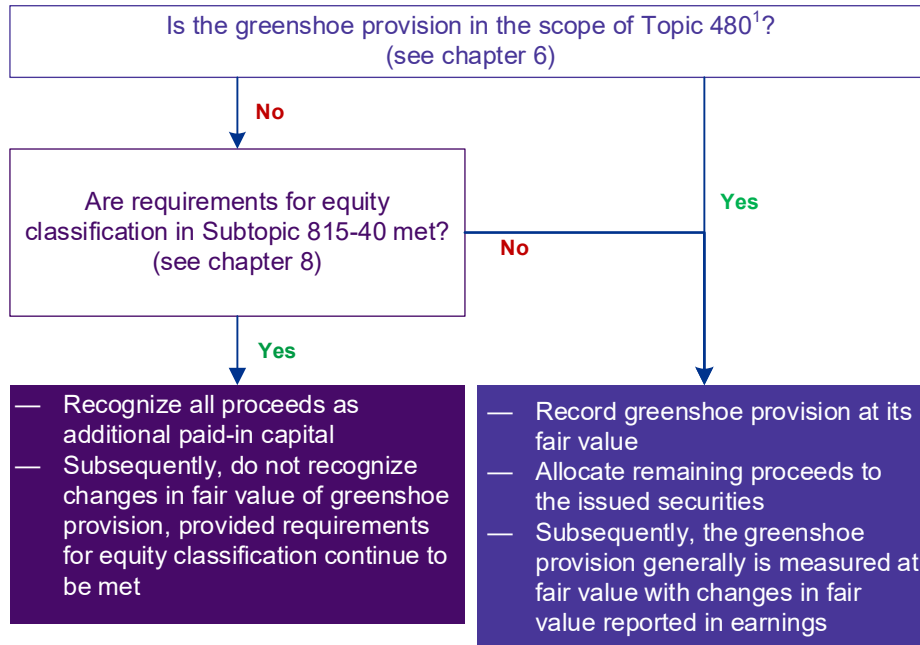
The first step in determining how to account for a greenshoe provision is to evaluate whether it is a freestanding instrument (see section 6.3). In our experience, most greenshoe provisions are freestanding because the underwriter holds the option to purchase additional shares, even when the underwriter does not hold the shares initially issued – e.g. because the underwriter has sold the securities to investors.

Proceeds from the securities issuance are generally allocated to a freestanding greenshoe provision.

The remaining discussion in this interpretive response relates to greenshoe provisions that are freestanding and do not relate to convertible instruments.

Greenshoe provisions related to issuance of equity securities

The following decision tree summarizes considerations for freestanding greenshoe provisions that relate to nonconvertible, equity-classified securities.



Note:

1. For example a greenshoe provision relating to the issuance of mandatorily redeemable instruments or preferred shares that are redeemable at the holder's option may be in the scope of Topic 480.

Greenshoe provisions related to issuance of debt securities

We believe freestanding greenshoe provisions that relate to debt securities should generally be initially recognized at fair value, with remaining proceeds allocated to the debt securities issued. Subsequently, the greenshoe provision should generally be measured at fair value with changes reported in earnings. See section 6.9 related to instruments in the scope of Topic 480, and section 8.13 related to instruments that do not meet all requirements for equity classification under Subtopic 815-40.

In our experience, a greenshoe provision related to debt securities frequently meets the definition of a derivative in Topic 815 and is not eligible for any scope exceptions. Even when it does not meet the definition of a derivative, we believe an entity should subsequently measure the provision at fair value through earnings based on the SEC's longstanding position on written options. Under this position, the SEC staff's view is that a written option is to be recorded at fair value with changes in fair value reported in earnings.

[\[815-10-S99-4\]](#)

5.4 Preferred shares



Excerpt from ASC 505-10

20 Glossary

Participation Rights

Contractual rights of security holders to receive dividends or returns from the security issuer's profits, cash flows, or returns on investments.

Preferred Stock

A security that has preferential rights compared to common stock.

Security

The evidence of debt or ownership or a related right. It includes options and warrants as well as debt and stock.

5.4.10 Overview

Preferred shares are a class of corporate ownership that has a higher claim on the issuer's assets and earnings than the entity's common shares. This typically includes the following preferences over common shares.

- **Liquidation preferences.** If the entity liquidates, preferred shareholders generally have a senior claim over common shareholders to net assets remaining after the entity's creditors and certain other parties are paid.
- **Dividend rights.** Dividends on preferred shares generally have to be paid to shareholders before dividends can be paid to common shareholders.

Preferred shareholders often do not have voting rights.

Preferred shares may be issued for a variety of reasons. For example, an early stage entity may issue preferred shares to venture capital firms with the understanding that the shares will either convert to common shares on a successful IPO or other liquidity event such as sale of the entity (with a preference over common shares).

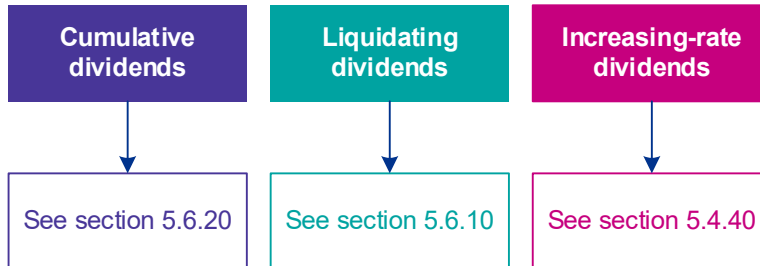
Preferred shares may also be issued to function like debt. For example, preferred shares may have a redemption date and a required dividend rate (similar to interest on a bond) and provide only limited opportunity for an investor to participate in potential increases in the value of the entity other than increases in value related to the entity's increasing credit quality. Further, some preferred shares are issued to function substantially like debt for tax purposes. Even when legal-form preferred shares have debt-like features, they may be classified as equity. Section 5.4.20 summarizes considerations related to accounting for preferred shares.

Dividend features of preferred shares

Preferred shares may have a stated dividend amount or rate, or a par value that indicates what the dividend will be. For example, 10% preferred shares with a \$100 par value makes the holder eligible for an annual dividend of \$10 per

share. If there is no par or stated value, the dividend preference is shown as a specific dollar amount.

There are several different types of preferred share dividends discussed in this chapter, including the following.



Other features of preferred shares

Other than the liquidation preferences and dividend rights discussed above, the following are some additional features often associated with preferred shares.

Rights	Description
Convertible	Investors may exchange their preferred shares for common shares or another class of equity at a predetermined ratio. See chapter 10.
Redeemable	Preferred shares that may be redeemed: <ul style="list-style-type: none"> — at the option of the holder (e.g. puttable shares); — based on the occurrence of an event; or — mandatorily as specified. Redeemable preferred shares may require presentation outside of permanent equity. This is the case even if the shares are not redeemable at the holder's option, but redemption is otherwise outside the control of the issuer. See discussion in section 6.4 on mandatorily redeemable financial instruments (which are classified as liabilities) and chapter 7 on temporary equity.
Callable	The issuer may call the outstanding preferred shares at specified future dates and at specified prices. In our experience, when an issuer calls preferred shares, dividends in arrears must be paid. See section 5.4.30.
Tranched	An entity issues preferred shares to an investor and the investor agrees to purchase more shares on one or more future dates and for predetermined prices. See section 5.4.50.
Other preferences	A US entity may attach preferences and/or restrictions to preferred shares as long as doing so does not violate its state incorporation law. As a consequence, an entity may issue more than one class of preferred shares.

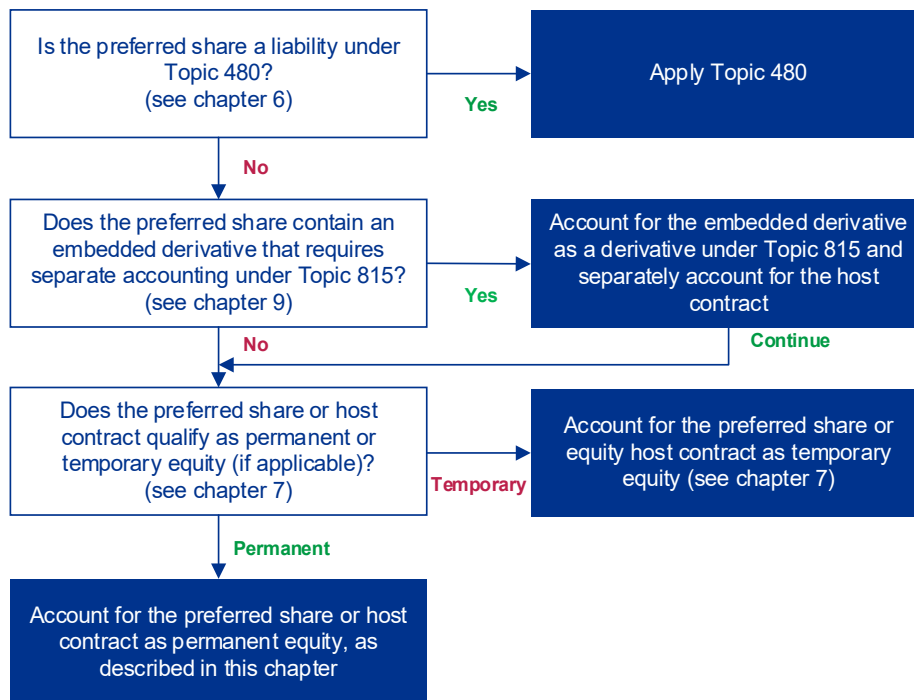
5.4.20 Accounting for preferred shares

Accounting for preferred shares can be complex and requires an understanding of the guidance surrounding debt and equity instruments. The guidance for EPS and embedded derivatives must also be understood; see KPMG Handbook, [Earnings per share](#), and chapter 9 on embedded derivatives.

When preferred shares are classified as permanent equity, the accounting for their issuance is similar to that of common shares, which is discussed in section 5.3 and illustrated in Example 5.3.10. However, in practice, most entities record the entire amount recognized for issuance as ‘preferred shares’ (i.e. no amounts are recognized as APIC), even if proceeds received exceed the par or stated amount of the preferred shares.

Question 5.4.10
How are preferred shares classified on the balance sheet?

Interpretive response: Preferred shares are classified on the balance sheet as permanent equity, temporary equity or liabilities, depending on their terms. The evaluation of preferred shares other than convertible preferred shares (see chapter 10) is summarized in the following decision tree.



Preferred shares are classified as liabilities if they qualify as such under Topic 480. See chapter 6 for discussion of instruments in the scope of Topic 480 and their related accounting. In brief, a preferred share is classified as a liability if it:

- is mandatorily redeemable (see section 6.4); or
- represents an unconditional obligation that will be settled in a variable number of shares, if, at inception, the monetary value of the obligation is based solely or predominantly on either (1) a fixed monetary amount or (2) a monetary amount determined in such a way that it does not expose the holder to the risks and rewards of ownership of the issuer's equity shares (see section 6.6).

If they do not qualify as liabilities under Topic 480, preferred shares are classified as equity. SEC registrants (and non-SEC registrants that elect to follow similar accounting guidance) need to determine whether to classify the shares as temporary equity under the SEC's temporary equity guidance. Essentially, a preferred share is classified as temporary equity when the issuer could be required to redeem it for cash or other assets. See chapter 7 for a full discussion of shares and other instruments that are classified as temporary equity and their related accounting.



Example 5.4.10

Issuance of preferred shares classified as permanent equity

Issuer issues 10,000 preferred shares with a par value of is \$1 per share for \$25 per share. The shares are classified as permanent equity and have no embedded features requiring separate accounting.

Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	250,000	
Preferred shares ¹		250,000
<i>To recognize issuance of preferred shares with stated par value.</i>		
Note:		
1. Typically, an issuer recognizes all proceeds to the preferred shares account. Alternatively, an issuer may record the par value to the preferred shares account (\$10,000) with the remaining proceeds from issuance (\$240,000) recorded as APIC.		



Example 5.4.15**

Allocation of proceeds when preferred shares are issued with warrants

Issuer issues the following instruments for total proceeds of \$50,000:

- 1,000 Series A preferred shares with a fair value of \$40,000; and
- 2,000 freestanding warrants to purchase Class A common shares with a fair value of \$20,000.

Issuer determines that the instruments are freestanding and each instrument qualifies for permanent equity classification. Because permanent-equity classified instruments are not subsequently measured at fair value, the issuance proceeds are allocated based on the instruments' relative fair values (see Question 5.3.10).

Allocation

Instrument	Fair value	Relative fair value % ¹	Allocated proceeds ²
Preferred shares	\$40,000	67%	\$33,500
Warrants	20,000	33%	16,500
Total	\$60,000	100%	\$50,000

Notes:

1. Fair value of instrument ÷ Total fair value (\$60,000).
2. Relative fair value % × Total proceeds (\$50,000).

Journal entry

Issuer records the following journal entry.

	Debit	Credit
Cash	50,000	
Preferred shares		33,500
Warrants		16,500
<i>To recognize issuance of preferred shares and warrants issued together for cash.</i>		



Question 5.4.15

How are permanent equity-classified preferred shares subsequently measured?

Interpretive response: US GAAP does not require an issuer to subsequently remeasure permanent equity-classified preferred shares. However, we believe that entities that are not required to apply the SEC's temporary equity guidance can make an accounting policy election to apply it to subsequently measure redeemable preferred shares, even if they do not elect to apply its related classification guidance.

See Questions 5.4.20 and 5.4.40 for further measurement guidance, and Question 7.2.30 for temporary equity measurement guidance.

**Question 5.4.20****When does an issuer recognize the liquidation preference for an equity-classified preferred share?**

Interpretive response: When the holder of an equity-classified preferred share is entitled to receive a defined amount of assets prior to common shareholders only upon final liquidation of the entity, the liquidation feature does not result in a requirement to remeasure the preferred share prior to liquidation (or adoption of the liquidation basis of accounting under Subtopic 205-30) unless the share is classified as temporary equity. Question 7.3.50 and section 7.3.40 consider the effect of liquidation clauses on temporary equity classification for SEC registrants (and non-SEC registrants that elect to follow similar accounting guidance).

Note: A liquidation preference that must be satisfied before final liquidation of the reporting entity may cause a preferred share to be liability-classified under Topic 480 instead of equity-classified. Section 6.4 discusses mandatorily redeemable financial instruments.

**Question 5.4.30****Are there additional presentation requirements for liquidation preferences?****Excerpt from ASC 505-10**

> Securities with Preferences

50-4 An entity that issues preferred stock (or other senior stock) that has a preference in involuntary liquidation considerably in excess of the par or stated value of the shares shall disclose the liquidation preference of the stock (the relationship between the preference in liquidation and the par or stated value of the shares). That disclosure shall be made in the equity section of the statement of financial position in the aggregate, either parenthetically or in short, rather than on a per-share basis or through disclosure in the notes.

Pending Content

Transition Date: (P) June 30, 2027; (N) June 30, 2027 | Transition Guidance: 105-10-65-7

50-4 An entity that issues **preferred stock** (or other senior stock) that has a preference in involuntary liquidation ~~considerably in excess of the~~ other than par or stated value of the shares shall disclose the liquidation preference of the stock (the relationship between the preference in liquidation and the par or stated value of the shares). That disclosure shall be made in the equity section of the statement of financial position in the aggregate, either parenthetically or in short, rather than on a per-share basis or through disclosure in the notes.



Excerpt from Regulation S-X Rule 4-08

General Notes to Financial Statements

The following is the text of Regulation S-X Rule 4-08, General Notes to Financial Statements (17 CFR 210.4-08).

If applicable to the person for which the financial statements are filed, the following shall be set forth on the face of the appropriate statement or in appropriately captioned notes. The information shall be provided for each statement required to be filed, except that the information required by paragraphs (b), (c), (d), (e) and (f) of this section shall be provided as of the most recent audited balance sheet being filed and for paragraph (j) of this section as specified therein. When specific statements are presented separately, the pertinent notes shall accompany such statements unless cross-referencing is appropriate....

- d. Preferred shares. Aggregate preferences on involuntary liquidation, if other than par or stated value, shall be shown parenthetically in the equity section of the balance sheet.

Interpretive response: Yes. US GAAP requires an entity to disclose a liquidation preference in the equity section of its balance sheet when the preference:

- is in involuntary liquidation; and
- is considerably in excess of the par or stated value of the shares.

The disclosure is required for the aggregate preference, instead of on a per-share basis. [505-10-50-4]

Further, SEC registrants are required to provide the disclosure when the preference is different from the par or stated value – i.e. even if the preference is not considerably in excess of those amounts. [S-X Rule 4-08]



Question 5.4.35

How does an issuer account for settlement of preferred shares that are equity-classified (including those in temporary equity)?

Interpretive response: It depends on the type of settlement, as summarized in the following table.

Repurchase or redemption	An issuer recognizes any difference between the amount paid for the repurchase or redemption and the carrying amount of the preferred shares in retained earnings as a deemed dividend (or contribution). This includes the following transactions. <ul style="list-style-type: none">— Repurchases by the issuer (see Question 5.4.40).— Redemptions by the holder.
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[260-10-S99-2, 2014 AICPA Conf]

	<ul style="list-style-type: none"> — Modifications of equity-classified preferred shares that are treated as extinguishments (see Questions 5.4.80 and 5.4.90). — Reclassification of preferred shares from equity to liability; see Question 10.2.70; see also section 7.4.60 for instruments classified in temporary equity.
<p>Conversion (other than induced conversion) [815-15-40-1]</p>	<p>It depends on whether the convertible preferred share's conversion feature is separately recorded.</p> <ul style="list-style-type: none"> — Conversion feature is not separately recorded: simple conversion accounting is applied with no gain or loss recognized when conversion occurs based on the original terms of a convertible instrument; see section 10.7.10. — Conversion option is separately recorded as an embedded derivative liability at the time of the conversion: the conversion is accounted for as an extinguishment, not as a conversion; see Question 10.7.50. — Conversion feature is separately recorded in equity at the time of conversion: the remaining unamortized discount or premium is recognized as deemed dividends (or contributions) to preferred shares. This accounting is applied if the conversion option was initially accounted for as a derivative but subsequently reclassified to equity; see Question 10.7.40.
<p>Induced conversion [260-10-S99-2]</p>	<p>A deemed dividend is recognized for the excess of:</p> <ul style="list-style-type: none"> — any incremental fair value of securities or other consideration paid by the issuer to the preferred shareholders, over — the fair value of the common shares issuable under the original conversion terms.

Section 3.3.50 of KPMG Handbook, [Earnings per share](#), discusses the EPS treatment when preferred shares are settled.

5.4.30 Callable preferred shares

Callable preferred shares are preferred shares that the issuer may buy back (i.e. call) from the investor at its option on specified future dates and at specified prices (i.e. the call price). An issuer may issue callable preferred shares to have additional flexibility over its cost of capital. For example, if market rates decrease, the issuer can call the preferred shares and issue a new instrument at a lower cost of capital.



Question 5.4.40

How are equity-classified callable preferred shares recognized and measured?

Interpretive response: Callable preferred shares are initially recognized and measured based on the proceeds received (or proceeds allocated, if applicable).

Subsequent measurement depends on whether the shares are classified in permanent or temporary equity (if applicable).

- **Permanent equity.** Callable preferred shares continue to be measured based on the proceeds received (or proceeds allocated, if applicable). If the preferred shares are called by the issuer, any difference between the call price and the shares' carrying amount is recorded in retained earnings when the shares are called and extinguished. [260-10-S99-2]
- **Temporary equity (if applicable).** See sections 7.4.40 to 7.4.50 for subsequent measurement guidance.

5.4.40 Increasing-rate preferred shares



Excerpt from SAB Topic 5.Q

Increasing Rate Preferred Stock

Facts: A registrant issues Class A and Class B nonredeemable preferred stock FN19 on 1/1/X1. Class A, by its terms, will pay no dividends during the years 20X1 through 20X3. Class B, by its terms, will pay dividends at annual rates of \$2, \$4 and \$6 per share in the years 20X1, 20X2 and 20X3, respectively. Beginning in the year 20X4 and thereafter as long as they remain outstanding, each instrument will pay dividends at an annual rate of \$8 per share. In all periods, the scheduled dividends are cumulative.

FN19 "Nonredeemable" preferred stock, as used in this SAB, refers to preferred stocks which are not redeemable or are redeemable only at the option of the issuer.

At the time of issuance, eight percent per annum was considered to be a market rate for dividend yield on Class A, given its characteristics other than scheduled cash dividend entitlements (voting rights, liquidation preference, etc.), as well as the registrant's financial condition and future economic prospects. Thus, the registrant could have expected to receive proceeds of approximately \$100 per share for Class A if the dividend rate of \$8 per share (the "perpetual dividend") had been in effect at date of issuance. In consideration of the dividend payment terms, however, Class A was issued for proceeds of \$79 ³/₈ per share. The difference, \$20 ⁵/₈, approximated the value of the absence of \$8 per share dividends annually for three years, discounted at 8%.

The issuance price of Class B shares was determined by a similar approach, based on the terms and characteristics of the Class B shares.

Question 1: How should preferred stocks of this general type (referred to as "increasing rate preferred stocks") be reported in the balance sheet?

Interpretive Response: As is normally the case with other types of securities, increasing rate preferred stock should be recorded initially at its fair value on date of issuance. Thereafter, the carrying amount should be increased periodically as discussed in the Interpretive Response to Question 2.

Question 2: Is it acceptable to recognize the dividend costs of increasing rate preferred stocks according to their stated dividend schedules?

Interpretive Response: No. The staff believes that when consideration received for preferred stocks reflects expectations of future dividend streams, as is normally the case with cumulative preferred stocks, any discount due to an absence of dividends (as with Class A) or gradually increasing dividends (as with Class B) for an initial period represents prepaid, unstated dividend cost. FN20 Recognizing the dividend cost of these instruments according to their stated dividend schedules would report Class A as being cost-free, and would report the cost of Class B at less than its effective cost, from the standpoint of common stock interests (i. e., for purposes of computing income applicable to common stock and earnings per common share) during the years 20X1 through 20X3.

FN20 As described in the "Facts" section of this issue, a registrant would receive less in proceeds for a preferred stock, if the stock were to pay less than its perpetual dividend for some initial period(s), than if it were to pay the perpetual dividend from date of issuance. The staff views the discount on increasing rate preferred stock as equivalent to a prepayment of dividends by the issuer, as though the issuer had concurrently (a) issued the stock with the perpetual dividend being payable from date of issuance, and (b) returned to the investor a portion of the proceeds representing the present value of certain future dividend entitlements which the investor agreed to forgo.

Accordingly, the staff believes that discounts on increasing rate preferred stock should be amortized over the period(s) preceding commencement of the perpetual dividend, by charging imputed dividend cost against retained earnings and increasing the carrying amount of the preferred stock by a corresponding amount. The discount at time of issuance should be computed as the present value of the difference between (a) dividends that will be payable, if any, in the period(s) preceding commencement of the perpetual dividend; and (b) the perpetual dividend amount for a corresponding number of periods; discounted at a market rate for dividend yield on preferred stocks that are comparable (other than with respect to dividend payment schedules) from an investment standpoint. The amortization in each period should be the amount which, together with any stated dividend for the period (ignoring fluctuations in stated dividend amounts that might result from variable rates, FN21 results in a constant rate of effective cost vis-a-vis the carrying amount of the preferred stock (the market rate that was used to compute the discount).

FN21 See Question 3 regarding variable increasing rate preferred stocks.

Simplified (ignoring quarterly calculations) application of this accounting to the Class A preferred stock described in the "Facts" section of this bulletin would produce the following results on a per share basis:

Carrying amount of preferred stock

	Beginning of Year (BOY)	Imputed Dividend (8% of carrying Amount at BOY)	End of year
Year 20X1	\$ 79.38	6.35	85.73
Year 20X2	85.73	6.86	92.59
Year 20X3	92.59	7.41	100.00

During 20X4 and thereafter, the stated dividend of \$8 measured against the carrying amount of \$100 FN22 would reflect dividend cost of 8%, the market rate at time of issuance.

FN22 It should be noted that the \$100 per share amount used in this issue is for illustrative purposes, and is not intended to imply that application of this issue will necessarily result in the carrying amount of a nonredeemable preferred stock being accreted to its par value, stated value, voluntary redemption value or involuntary liquidation value.

The staff believes that existing authoritative literature, while not explicitly addressing increasing rate preferred stocks, implicitly calls for the accounting described in this bulletin.

The pervasive, fundamental principle of accrual accounting would, in the staff's view, preclude registrants from recognizing the dividend cost on the basis of whatever cash payment schedule might be arranged. Furthermore, recognition of the effective cost of unstated rights and privileges is well-established in accounting, and is specifically called for by FASB ASC Subtopic 835-30, Interest—Imputation of Interest, and Topic 3.C of this codification for unstated interest costs of debt capital and unstated dividend costs of redeemable preferred stock capital, respectively. The staff believes that the requirement to recognize the effective periodic cost of capital applies also to nonredeemable preferred stocks because, for that purpose, the distinction between debt capital and preferred equity capital (whether redeemable FN23 or nonredeemable) is irrelevant from the standpoint of common stock interests.

FN23 Application of the interest method with respect to redeemable preferred stocks pursuant to Topic 3.C results in accounting consistent with the provisions of this bulletin irrespective of whether the redeemable preferred stocks have constant or increasing stated dividend rates. The interest method, as described in FASB ASC Subtopic 835-30, produces a constant effective periodic rate of cost that is comprised of amortization of discount as well as the stated cost in each period.

Question 3: Would the accounting for discounts on increasing rate preferred stock be affected by variable stated dividend rates?

Interpretive Response: No. If stated dividends on an increasing rate preferred stock are variable, computations of initial discount and subsequent amortization should be based on the value of the applicable index at date of issuance and should not be affected by subsequent changes in the index.

For example, assume that a preferred stock issued 1/1/X1 is scheduled to pay dividends at annual rates, applied to the stock's par value, equal to 20% of the actual (fluctuating) market yield on a particular Treasury security in 20X1 and 20X2, and 90% of the fluctuating market yield in 20X3 and thereafter. The discount would be computed as the present value of a two-year dividend stream equal to 70% (90% less 20%) of the 1/1/X1 Treasury security yield, annually, on the stock's par value. The discount would be amortized in years 20X1 and 20X2 so that, together with 20% of the 1/1/X1 Treasury yield on the stock's par value, a constant rate of cost vis-a-vis the stock's carrying amount would result. Changes in the Treasury security yield during 20X1 and 20X2 would, of course, cause the rate of total reported preferred dividend cost (amortization of discount plus cash dividends) in those years to be more or less than the rate indicated by discount amortization plus 20% of the 1/1/X1 Treasury security yield. However, the fluctuations would be due solely to the impact of changes in the index on the stated dividends for those periods.

Increasing-rate preferred shares include shares that have the following dividend features:

- pay no or low dividends early in their life, and subsequently pay dividends – e.g. no dividends for two years after issuance and at a stated rate of 8% thereafter; and/or
- pay dividends at a rate that increases the longer the instrument is outstanding.

SEC guidance requires any discount from the issuance of increasing-rate preferred shares to be amortized. [\[SAB Topic 5.Q\]](#)

Because an entity that issues increasing-rate preferred shares is faced with paying higher dividends in the future, at some point in the future it may be economically compelled to redeem the shares. Such an increased rate does not, itself, result in an increasing-rate preferred share being classified as a liability under Topic 480 (see Question 6.4.60).



Example 5.4.20

Increasing-rate preferred shares

This example is based on the facts in SAB Topic 5.Q, Question 2 (paragraph 505-10-S99-7).

Issuer issues Class A and Class B \$100 par nonredeemable preferred shares on January 1, Year 1.

Dividends on Class A and Class B shares are cumulative as follows.

Year	Class A	Class B
Year 1	Zero	\$2
Year 2	Zero	4
Year 3	Zero	6

Year	Class A	Class B
Year 4 and thereafter	\$8	8
Issuance price ¹	\$79.38	\$89.43
Note: 1. The difference between \$100 and the issuance price for each class approximates the value of the absence of a full \$8 per share dividend in each of Years 1 to 3, discounted at 8%.		

At the time of issuance, 8% per annum (i.e. a perpetual dividend of 8%) is considered the market rate for the dividend yield on each class of shares. Therefore, if the dividend rate had been in effect at the issuance date (instead of beginning in Year 4), Issuer could have expected to receive proceeds of approximately \$100 per share for each class of shares. However, because each class had dividend payment terms differing from that, both classes are issued for proceeds less than \$100 per share.

Issuer classifies the preferred shares as equity because they are not mandatorily redeemable.

Class A preferred shares

The following table summarizes dividend cost for each Class A preferred share during Years 1 to 3. Discount amortization represents an imputed 8% dividend.

Year	Carrying amount, beginning of year	Dividend cost		Carrying amount, end of year ²
		Cash paid for dividends	Discount amortization ¹	
1	\$79.38	\$0.00	\$6.35	\$85.73
2	85.73	0.00	6.86	92.59
3	92.59	0.00	7.41	100.00
Notes: 1. (Carrying amount, beginning of year × 8%) – Cash paid for dividends. 2. Carrying amount, beginning of year + Discount amortization.				

Issuer records the following journal entry upon issuance of each share of \$100 par value Class A nonredeemable preferred shares.

	Debit	Credit
Cash	79.38	
Discount on Class A preferred shares ¹	20.62	
Class A preferred shares ¹		100.00
<i>To recognize issuance of Class A preferred shares.</i>		
Note: 1. The net carrying amount of the preferred shares at the issuance date is \$79.38: \$100 – \$20.62.		

Issuer records a journal entry at the end of each year to reflect amortization of the discount.

Year 1

	<i>Debit</i>	<i>Credit</i>
Retained earnings	6.35	
Discount on Class A preferred shares		6.35
<i>To recognize amortization of increasing-rate preferred shares.</i>		

Year 2

	<i>Debit</i>	<i>Credit</i>
Retained earnings	6.86	
Discount on Class A preferred shares		6.86
<i>To recognize amortization of increasing-rate preferred shares.</i>		

Year 3

	<i>Debit</i>	<i>Credit</i>
Retained earnings	7.41	
Discount on Class A preferred shares		7.41
<i>To recognize amortization of increasing-rate preferred shares.</i>		

Class B preferred shares

The following table summarizes dividend cost for each Class B preferred share during Years 1 to 3. Discount amortization represents the amount necessary to result in an imputed 8% dividend.

Year	Carrying amount, beginning of year	Dividend cost		Carrying amount, end of year ²
		Cash paid for dividends	Discount amortization ¹	
1	\$89.43	\$2.00	\$5.15	\$94.58
2	94.58	4.00	3.57	98.15
3	98.15	6.00	1.85	100.00

Notes:

- (Carrying amount, beginning of year × 8%) – Cash paid for dividends.
- Carrying amount, beginning of year + Discount amortization.

Issuer records the following journal entry upon issuance of each share of \$100 par value Class B nonredeemable preferred shares.

	<i>Debit</i>	<i>Credit</i>
Cash	89.43	
Discount on Class B preferred shares ¹	10.57	
Class B preferred shares ¹		100.00
<i>To recognize issuance of Class B preferred shares.</i>		
Note:		
1. The net carrying amount of the preferred shares at the issuance date is \$89.43: \$100 [*] – \$10.57.		

Issuer records a journal entry at the end of each year to reflect dividends paid and amortization of the discount.

Year 1

	<i>Debit</i>	<i>Credit</i>
Retained earnings	7.15	
Cash		2.00
Discount on preferred shares		5.15
<i>To recognize dividends paid and amortization of increasing-rate preferred shares.</i>		

Year 2

	<i>Debit</i>	<i>Credit</i>
Retained earnings	7.57	
Cash		4.00
Discount on preferred shares		3.57
<i>To recognize dividends paid and amortization of increasing-rate preferred shares.</i>		

Year 3

	<i>Debit</i>	<i>Credit</i>
Retained earnings	7.85	
Cash		6.00
Discount on preferred shares		1.85
<i>To recognize dividends paid and amortization of increasing-rate preferred shares.</i>		

**Example 5.4.30****Increasing-rate preferred shares with variable stated dividend rates**

This example is based on the facts in SAB Topic 5.Q, Question 3 (paragraph 505-10-S99-7).

Issuer issues nonredeemable \$100 par value preferred shares on January 1, Year 1. The following relates to the dividends on the preferred shares.

- The preferred shares pay dividends at annual rates, applied to the shares' par value, equal to:
 - 20% of the actual (fluctuating) market yield on a particular Treasury security in Years 1 and 2; and
 - 90% of the fluctuating market yield in Year 3 and thereafter.
- At the time of issuance:
 - a market rate for a preferred share with comparable features was 90% of the yield on 10-year Treasury bonds; and
 - the rate on the particular Treasury security was 5%.

The issuance price is calculated as follows.

Rate on particular Treasury security ('Treasury rate') at inception	5.00%
Market rate for preferred share at inception ¹	4.50%
Cash dividend rate in Years 1 and 2 ²	1.00%
Difference between market rate for preferred shares at inception and cash dividend rate in Years 1 and 2	3.50%
Issuance price ³	\$93.45
Notes:	
1. 90% of Treasury rate at inception.	
2. 20% of Treasury rate at inception.	
3. The difference between \$100 par value and the \$93.45 issuance price approximates the value of the absence of a full \$4.50 per share dividend (i.e. absence of a full market rate dividend) in each of Years 1 and 2, discounted at 4.5%.	

Issuer records the issuance of variable-rate preferred shares as follows.

	<i>Debit</i>	<i>Credit</i>
Cash ¹	93.45	
Discount on preferred share	6.55	
Preferred shares		100.00
<i>To recognize issuance of variable-rate preferred shares.</i>		
Note:		
1. The net carrying amount of the preferred shares at the issuance date is \$93.45: \$100 – \$6.55.		

Changes in the Treasury rate during Years 1 and 2 do not affect the discount accretion. However, the change in yield changes the cash dividend paid to investors and therefore total dividend cost as reflected in the following scenarios.

Scenario 1: Treasury rate does not change during Years 1 to 3

The following table summarizes dividend cost for each preferred share in Years 1 to 3. Discount amortization represents the amount necessary to result in an imputed 4.5% dividend.

Year	Carrying amount, beginning of year	Dividend cost		Carrying amount, end of year ²
		Cash paid for dividends	Discount amortization ¹	
1	\$93.45	\$1.00	\$3.21	\$96.66
2	96.66	1.00	3.34	100.00
3	100.00	4.50	0.00	100.00
Total		\$6.50	\$6.55	

Notes:

1. (Carrying amount, beginning of year × 4.5%) – Cash paid for dividends.
2. Carrying amount, beginning of year + Discount amortization.

Issuer records a journal entry at the end of each year to reflect dividends paid and amortization of the discount as follows.

Year 1

	Debit	Credit
Retained earnings	4.21	
Cash		1.00
Discount on preferred shares		3.21
<i>To recognize dividends paid and amortization of increasing-rate preferred shares.</i>		

Year 2

	Debit	Credit
Retained earnings	4.34	
Cash		1.00
Discount on preferred shares		3.34
<i>To recognize dividends paid and amortization of increasing-rate preferred shares.</i>		

Year 3

	<i>Debit</i>	<i>Credit</i>
Retained earnings	4.50	
Cash		4.50
<i>To recognize dividends paid on increasing-rate preferred shares.</i>		

The discount is accreted in Years 1 and 2 so that, together with 20% of the Treasury rate on the shares' par value, a constant rate of dividend on the shares' carrying amount results.

Scenario 2: Treasury rate changes during Years 1 to 3

In this Scenario, assume the Treasury rate was as follows during Years 1 to 3.

Year	Treasury rate	Dividend paid ¹
1	5.00%	\$1.00
2	4.50%	\$0.90
3	5.50%	\$4.95

Note:

- In Years 1 and 2, represents 20% of the Treasury rate. In Year 3, represents 90% of the Treasury rate.

The following table summarizes dividend cost for each preferred share during Years 1 to 3. Discount amortization is unchanged; however, total dividend cost is different from Scenario 1 because of changes in the cash paid for dividends.

Year	Carrying amount, beginning of year	Dividend cost		Carrying amount, end of year ²
		Cash paid for dividends	Discount amortization ¹	
1	\$93.45	\$1.00	\$3.21	\$96.66
2	96.66	0.90	3.34	100.00
3	100.00	4.95	0.00	100.00
Total		\$6.85	\$6.55	

Notes:

- Equals amortization from Scenario 1.
- Carrying amount, beginning of year + Discount amortization.

Issuer records a journal entry at the end of each year to reflect dividends paid and amortization of the discount.

Year 1

	<i>Debit</i>	<i>Credit</i>
Retained earnings	4.21	
Cash		1.00
Discount on preferred shares		3.21
<i>To recognize dividends paid and amortization of increasing-rate preferred shares.</i>		

Year 2

	<i>Debit</i>	<i>Credit</i>
Retained earnings	4.24	
Cash		0.90
Discount on preferred shares		3.34
<i>To recognize dividends paid and amortization of increasing-rate preferred shares.</i>		

Year 3

	<i>Debit</i>	<i>Credit</i>
Retained earnings	4.95	
Cash		4.95
<i>To recognize dividends paid on increasing-rate preferred shares.</i>		

Changes in the Treasury rate during Years 1 and 2 cause the rate of total reported preferred dividend amount (amortization of discount plus cash dividends) in those years to equate to 90% of the then-Treasury rate. The fluctuations are then due solely to the effect of changes in the index on the stated dividends for those periods.

5.4.50 Tranched preferred shares#

Some preferred shares are issued with a future right or obligation to issue additional preferred shares, often referred to as a future "tranche". That future right or obligation may:

- be conditional on the issuer reaching certain milestones;
- be at the option of the investor (e.g. a written call option) or the issuer (e.g. a purchased put option) or be an obligation (e.g. a forward agreement);
- relate to preferred shares that are redeemable (e.g. puttable by the investor), convertible or perpetual – and is typically for a fixed number of shares for a fixed dollar amount or the par amount of the preferred share.

In certain transactions, if the investor defaults on providing the cash for the future tranche, the originally issued preferred shares may be cancelled for no consideration or may automatically convert into another class of shares that equal a nominal value.

An issuer may issue tranching preferred shares for a variety of reasons, most notably to align its projected capital needs with specific performance goals of its new product development. Specifically, the issuer can benefit by locking in capital contributions and the related costs of raising capital, and the investor can benefit from deferred cash funding for its investments (if certain performance goals are met)

Careful consideration is required about whether the future tranche represents a future right or obligation to each party, taking into account whether the preferred shareholders control the issuer's board of directors such that an option of the issuer actually represents an option of the investor due to influence of the preferred shareholders over the board. A future tranche may be one of the following:

- a forward contract (if the issuer must sell and the investor must purchase shares in the future);
- a purchased put option (if the issuer has the right but not the obligation to issue additional shares to the investor); or
- a written call option (if the investor has the right but not the obligation to purchase additional shares from the issuer).

In addition, such future tranche may be conditional (e.g. a milestone must be met) prior to exercise. See section 11.8 for an illustration of this guidance.

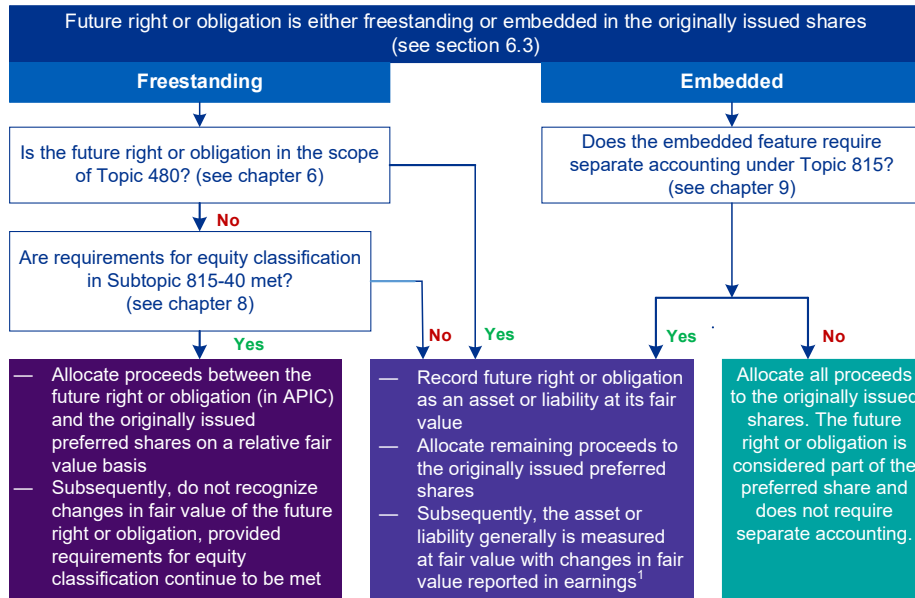


Question 5.4.50

How are tranching preferred shares accounted for?

Interpretive response: Tranching preferred share transactions are highly tailored based on the needs of the issuer and the investor. Therefore, the accounting for these arrangements requires a careful analysis of all the relevant facts and circumstances.

The following decision tree summarizes considerations in determining how the issuer accounts for the future right or obligation associated with tranching preferred shares. See section 11.8 for illustrative examples.



1. For subsequent measurement guidance, see:
- Instruments in the scope of Topic 480: section 6.10; and
 - Instruments that do not meet all requirements for equity classification under Subtopic 815-40: section 8.13.20

5.4.60 Extinguishment vs modification of preferred shares

Subtopic 470-50 addresses the debtor’s accounting for modifications and extinguishments of debt instruments, including mandatorily redeemable preferred shares that are accounted for as debt under Topic 480. However, there is no explicit US GAAP guidance on when amendments to the terms of equity-classified preferred shares represent an extinguishment or a modification of those shares.



Question 5.4.60

How does an issuer determine whether an amendment to (or an exchange of) preferred shares is a modification or extinguishment?


Interpretive response: US GAAP does not provide guidance. However, the SEC staff has expressed its view, stating that the significance of an amendment to the terms of the preferred shares determines whether the amendment represents an extinguishment of the existing preferred shares. An amendment can be of such significance that it represents an extinguishment. In contrast, the staff believes that even though an amendment may be important to the parties, it might not be significant enough to represent an extinguishment, in which case it is more appropriately characterized as a modification. [\[2014 AICPA Conf\]](#)

The SEC staff observed that the most common approach to determining whether an amendment or exchange is a modification or an extinguishment is to qualitatively assess new, removed and changed contractual terms. Also important is the business purpose for the change and how it may influence the investor’s economic decisions. If an issuer assesses these changes to be significant, it treats the amendment or exchange as an extinguishment. Otherwise, the change is considered a modification to the preferred shares.

The staff further observed that there are methods other than the qualitative approach that are used in practice and provided the following insights about those other methods. For each method, if the condition is met then the amendment or exchange is accounted for as an extinguishment. If the condition is not met, it is treated as a modification.

	Condition to be met for the amendment or exchange to be considered an extinguishment
Fair value approach	The fair value of the preferred shares after the amendment is compared to the fair value of the preferred shares immediately before the amendment. If the change in the fair value of the preferred shares is 10% or greater than the fair value of the preferred shares immediately before the amendment, the preferred shares are considered substantially different.
Cash flow approach	Same as the fair value approach, except that contractual cash flows are evaluated instead of the fair value. The SEC staff cautioned that this approach may only be reasonable when the preferred shares have well-defined periodic contractual cash flows. In our experience, many preferred shares do not have well-defined contractual cash flows – e.g. there is no maturity date for a final cash flow of the instrument. Therefore, we believe this approach may require significant assumptions and judgment.
Legal approach	New shares are issued. The SEC staff cautioned that the legal form is merely one consideration and should not be viewed as determinative. Because this approach is solely form driven, we believe that it generally does not provide persuasive evidence without considering one or more of the other approaches.

See Question 3.3.100 of KPMG Handbook, [Earnings per share](#), for EPS guidance for the exchange of preferred shares. And see Question 5.4.100 regarding certain amendments to preferred shares with dividends linked to LIBOR.

 **Question 5.4.70**
How is a preferred share modification transaction accounted for?

Interpretive response: The SEC staff believes that if an entity concludes that an amendment to (or exchange of) preferred shares is a modification, the entity

may analogize to the modification guidance in Subtopic 718-20 for modifications to equity-classified share-based payment awards. [\[2014 AICPA Conf\]](#)

- **Measurement.** If the modified instrument's fair value exceeds the fair value of the original instrument, the entity recognizes the additional fair value to reflect the modification. See section 5 of KPMG Handbook, [Share-based payment](#), for further discussion on modifications.
- **Recognition.** The staff has not objected to recording the increase in fair value to retained earnings as a deemed dividend from the entity to the preferred shareholders. The staff also believes that in certain unique circumstances it may be appropriate to reflect the increase in fair value as a charge to earnings as a form of compensation for agreeing to restructure. While the staff has accepted both views, the conclusion is highly dependent on the underlying purpose for, and circumstances surrounding, the modification.

See also Question 5.4.100 regarding certain amendments to preferred shares with dividends linked to LIBOR.



Question 5.4.80

How is a preferred share extinguishment transaction accounted for?

Interpretive response: If an issuer concludes that an amendment to (or exchange of) preferred shares is an extinguishment, a new basis of accounting for the modified or exchanged preferred shares results and the old instrument is accounted for as a redemption. The issuer recognizes the modified or exchanged shares at their fair value, derecognizes the old instrument's carrying amount, with the difference recorded in retained earnings. [\[260-10-S99-2\]](#)

See also section 3.3.50 of KPMG Handbook, [Earnings per share](#), for discussion on the EPS treatment when preferred shares are redeemed.



Question 5.4.90

How is the exchange of nonconvertible preferred shares for common shares accounted for?

Interpretive response: The exchange is treated as an extinguishment of the preferred shares. Therefore, the new shares are given a new accounting basis and the extinguished shares are accounted for as a redemption. The entity charges the excess of the fair value of the common shares issued over the recorded amount of the preferred shares to retained earnings. [\[260-10-S99-2\]](#)

If the entity classified the preferred shares as a liability, it records the difference as a gain or loss on the extinguishment of debt (see section 4.5).



Question 5.4.100

Does an amendment to the terms of preferred shares to replace a LIBOR-based index for paying dividends represent a modification or extinguishment?

Background: Market-wide efforts to transition away from LIBOR and other interbank offered rates as reference rates are ongoing. Namely, ICE Benchmark Administration Limited (LIBOR's administrator) ceased publishing certain USD LIBOR settings (1-week and 2-month, which are two lesser-used USD LIBOR settings) and all GBP, EUR, CHF and JPY LIBOR settings after December 31, 2021. Further, it has announced that it expects to cease publishing the remaining USD LIBOR settings (Overnight, 1-month, 3-month, 6-month and 12-month, which are the major USD LIBOR settings) after June 30, 2023.

In connection with its transition away from LIBOR, an entity may amend the terms of its preferred shares to replace a LIBOR-based index for paying dividends with an alternative index.

Topic 848 (reference rate reform) provides entities with optional guidance to ease the potential burden associated with transitioning away from LIBOR and other reference rates that are expected to be discontinued if certain conditions are met. It includes a general principle permitting an entity not to apply otherwise applicable US GAAP that would require considering whether an event requires contract remeasurement at the modification date or reassessment of a previous accounting determination. [848-20-35-4]

However, US GAAP does not provide guidance on how to account for modifications of equity-classified preferred shares (see Question 5.4.60 to 5.4.70), and Topic 848 does not specifically address amendments to equity-classified preferred shares.

Interpretive response: We believe the issuer should apply the SEC staff views for determining whether the amendment is a modification or extinguishment (see Question 5.4.60), and for accounting for the amendment (see Question 5.4.70 for modifications and Question 5.4.80 for extinguishments).

The SEC staff has addressed its views about accounting for an amendment of an equity-classified perpetual preferred share to replace the LIBOR-based index when the following conditions are met: [2019 AICPA Conf, ARRC 12-19]

- the preferred shares have LIBOR-linked dividends;
- the amendments replace the current LIBOR index with a replacement index upon the cessation of LIBOR (in anticipation of the cessation of LIBOR);
- the sole business purpose of the amendments made to the preferred shares is to designate a new variable index to replace LIBOR that is currently being used to determine the preferred share dividend amounts (as opposed to transferring value from one party to another); and
- no cash is exchanged between issuer and investor.

When those conditions are met, the SEC staff does not object to the accounting summarized in the following table. [2019 AICPA Conf, ARRC 12-19]

Accounting aspect	Application guidance
Determining whether the amendment is a modification or extinguishment	<p>When the issuer applies a qualitative approach (see Question 5.4.60), it may conclude that the amendment is a modification.</p> <p>This conclusion considers the business purpose for the changes and how the changes may influence the holder's economic decisions.</p>
Recognizing the modification	<p>The issuer is not required to recognize incremental fair value (if any), including not being required to recognize a deemed dividend in equity (or EPS).</p> <p>This conclusion considers that the sole business purpose of the modification was to permanently replace LIBOR and not to transfer value to the holder. Further, the conclusion presumes that the modification will be negotiated at fair value and that market participants increasingly consider the expected cessation of LIBOR when determining fair value of LIBOR-linked contracts. As a result, any potential increase in fair value from the modification would be minimal.</p>

5.5 Retained earnings and APIC

5.5.10 Retained earnings

Retained earnings are the cumulative earnings of an entity in excess of the amounts it has distributed to its shareholders or owners. They do not necessarily represent an amount available for immediate distribution to shareholders because the entity may use them for investments in future growth by expanding operations, or other business purposes. Further, an entity may be restricted from distributing retained earnings for legal, contractual or other reasons. For example, a debt or preferred share agreement may prohibit an entity from paying dividends, or a state law relating to the acquisition of an entity's own shares may restrict the availability of retained earnings for payment of dividends.

The types of transactions that affect retained earnings include:

- current period earnings or losses;
- dividends paid on common shares;
- dividends paid on preferred shares classified as equity, including dividends on redeemable preferred shares presented as temporary equity by SEC registrants;
- accretion or amortization of discounts on preferred shares classified as equity, including on redeemable preferred shares presented as temporary equity by SEC registrants;
- certain losses on treasury shares transactions;

- prior-period adjustments and the cumulative effect of a change to a new accounting principle that is applied retrospectively under Topic 250; and
- quasi-reorganizations and fresh-start accounting under Topic 852.



Question 5.5.10

How are appropriated retained earnings presented and how do they affect accounting for the item underlying the appropriation?



Excerpt from ASC 505-10

> Appropriations of Retained Earnings

45-3 Appropriation of retained earnings is permitted, provided that it is shown within the shareholders' equity section of the balance sheet and is clearly identified as an appropriation of retained earnings.

45-4 Costs or losses shall not be charged to an appropriation of retained earnings, and no part of the appropriation shall be transferred to income.

Background: Appropriated retained earnings are retained earnings that have been earmarked for a specific purpose, making them unavailable for distribution to shareholders as dividends. A common reason for appropriating retained earnings is to provide for loss contingencies (e.g. pending litigation for which an accrual under US GAAP is not permitted). Appropriating retained earnings generally requires approval of the board of directors.

Interpretive response: Appropriated retained earnings are clearly identified in shareholders' equity regardless of the reason for which they are appropriated. The appropriation results in only a presentation change of retained earnings and does not otherwise affect the accounting for the related item.

For example, if retained earnings are appropriated for a loss contingency, they are presented as 'appropriated' for that amount. Any costs or losses associated with the loss contingency are not charged directly to retained earnings; instead, they are expensed when accrued in the usual way. Further, appropriated retained earnings are not transferred to income if the actual amount of the loss contingency is less than the amount appropriated. When the loss contingency is resolved, the amount in retained earnings is no longer identified as appropriated on the balance sheet. [505-10-45-3 – 45-4]

5.5.20 Additional paid-in capital



Excerpt from ASC 505-10

25-1 Additional paid-in capital, however created, shall not be used to relieve income of the current or future years of charges that would otherwise be made to the income statement. See paragraph 852-20-25-2 for an exception to this guidance related to reorganizations.

25-3 Paragraphs 323-10-25-3 through 25-5 provide guidance on accounting for share-based compensation granted by an investor to employees or nonemployees of an equity method investee that provide goods or services to the investee that are used or consumed in the investee's operations. An investee shall recognize the costs of the share-based payment incurred by the investor on its behalf, and a corresponding capital contribution, as the costs are incurred on its behalf (that is, in the same period(s) as if the investor had paid cash to employees and nonemployees of the investee following the guidance in Topic 718 on stock compensation.

APIC includes proceeds from an issuance of common shares in excess of the par or stated value. It may also be affected by various other transactions or events. The following are examples of transactions that may affect APIC. [505-10-25-1]

Transaction	Addressed in
Dividends legally declared out of APIC	Section 5.6
Convertible debt issued at a substantial premium	Chapter 10
Treasury share transactions	Section 5.8
Payments to customers in the form of equity	KPMG Handbook, Revenue recognition
Transactions involving share-based payments to employees and nonemployees, including those of an equity method investee	KPMG Handbook, Share-based payment
Equity derivatives issued in financing transactions (e.g. freestanding stock purchase warrants issued with debt) if those instruments qualify for classification as equity in the issuer's financial statements	Chapter 8; chapter 10
Certain modifications or exchanges of freestanding equity-classified written call options when their nature is an equity offering	Section 8.13.40
Contingently redeemable shares that become mandatorily redeemable upon resolution of a contingency	Section 6.4
Undistributed earnings of an S corporation on the date it terminates its Subchapter S election	Question 5.5.30
A retained deficit eliminated in a quasi-reorganization	Subtopic 852-20

Transaction	Addressed in
Certain costs incurred issuing equity securities, including a shelf registration	SAB Topic 5.A (paragraph 340-10-S99-1)
Difference between the cost and fair value of shares in an ESOP when the shares are committed to be released upon termination of the ESOP	Subtopic 718-40



Question 5.5.20

Are proceeds received from the disgorgement of short-swing profits by a shareholder recorded as APIC?

Interpretive response: Yes. Short-swing profits are profits realized in any period less than six months by corporate insiders in their own corporation's shares. Transactions producing short-swing profits are prohibited under Section 16(b) of the Securities Exchange Act of 1934, except in very limited circumstances. Disgorgement of short-swing profits can be pursued either by the issuer or the owner of any security of the issuer in the name of and on behalf of the issuer if the issuer fails or refuses to bring such suit within 60 days after request.

We believe the receipt of disgorged short-swing profits represents an equity contribution to the entity by its owners. Therefore, an entity includes the proceeds it receives from the disgorgement of short-swing profits in APIC. This is consistent with the concept that most of an entity's transactions in its own shares are capital transactions – i.e. transferring the ownership of the entity's shares or the rights associated with owning the entity's shares. Those transactions do not result in recognition of income or expense by the entity.



Question 5.5.30

How are undistributed earnings of an S corporation presented when its S election is terminated?



Excerpt from SAB Topic 4.B

S Corporations

Facts: An S corporation has undistributed earnings on the date its S election is terminated.

Question: How should such earnings be reflected in the financial statements?

Interpretive Response: Such earnings must be included in the financial statements as additional paid-in capital. This assumes a constructive

distribution to the owners followed by a contribution to the capital of the corporation.

Interpretive response: They are presented as APIC. In effect, such undistributed earnings represent a constructive distribution followed by a contribution. [SAB Topic 4.B]

5.6 Dividends

5.6.10 Overview

Dividends are distributions of an entity's equity to its shareholders. These distributions can be from earnings or may represent a return of the entity's capital (e.g. a liquidating dividend). Further, they can be paid on either preferred or common shares and in the form of cash, other assets (called dividends-in-kind) or shares. This section explains accounting for dividends in cash and other assets, and section 5.7 explains accounting for stock dividends.

Several factors influence an entity's decision to pay dividends, including the availability of cash, internal investment opportunities, and the ability to sustain the dividends. For example, an entity with a growing business may retain its earnings to invest in expansion of the business. Further, certain contractual arrangements may restrict an entity's ability to pay dividends – e.g. a loan covenant or similar restriction on a preferred shares agreement.

Conversely, a more mature entity that generates enough cash to maintain its business may pay dividends to return some of its profits to shareholders. In fact, many entities establish a dividend policy or practice to provide a predictable return on investment for their shareholders.



Question 5.6.10

When and how are dividends accounted for?

Interpretive response: The following are the key dates relating to dividends.

Declaration date	Date on which the board of directors declares a dividend
Ex-dividend date	Date on which the shares start trading without the value of the next dividend payment (see also Question 5.7.90)
Record date	Dividends are payable to shares on record as of the record date
Payment date	Date on which the dividends are paid – i.e. the date actual cash payment is made to the shareholder of record

The declaration date is the date the entity becomes liable for the dividend payment. On this date, the entity:

- records a current liability for the amount of the dividend – including PIK dividends (see section 5.6.30) – unless the dividend is in the form of a stock dividend; and
- reduces retained earnings unless the dividend is legally declared out of APIC (e.g. a liquidating dividend).

Prior to the declaration date, the entity does not record a liability for the dividends. [TPA 4210.01]

However, for some equity shares, an entity may be required to recognize deemed dividends prior to the declaration date – e.g. certain preferred shares that are classified in temporary equity and that are currently redeemable or for which redemption is probable (see section 7.4). Generally, those requirements result in recognizing such dividends in the equity section of the balance sheet (e.g. through reducing retained earnings and increasing the equity share’s carrying amount) and not recognizing the dividend liability until the declaration date. See also KPMG Handbook, [Earnings per share](#), for discussion on the EPS treatment of such deemed dividends (e.g. section 3.3.20).

Liquidating dividends

Liquidating dividends are a return of the shareholders’ investment instead of a distribution of profits and do not decrease retained earnings. Instead, on the declaration date, an entity records a liquidating dividend in a contra-account to APIC. It may label this account as ‘liquidating dividends’ or some other appropriate caption – e.g. ‘capital repayment’ or ‘capital returned.’ [TPA 4210.01]



Example 5.6.10

Cash dividend declared by the board of directors

On July 25, Year 1, Issuer declares a cash dividend of \$0.50 per share to the common shareholders of record on August 1, Year 1.

The following are the key dates (Year 1):

- July 25: declaration date
- August 1: record date – 100,000 ABC common shares are outstanding
- August 25: payment date (dividends are paid)

The dividend becomes a liability on July 25, the declaration date. Issuer records the following journal entry on that date.

	<i>Debit</i>	<i>Credit</i>
Retained earnings	50,000	
Dividends payable ¹		50,000
<i>To recognize declaration of cash dividend.</i>		
Note:		
1. 100,000 shares × \$0.50 per share.		

No journal entry is necessary on the record date. When the dividend is paid on August 25, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Dividends payable	50,000	
Cash		50,000
<i>To recognize payment of cash dividend.</i>		



Question 5.6.20

Can an entity pay a dividend in excess of its retained earnings?

Interpretive response: It depends. State corporate law may limit dividend payments to the amount of an entity's retained earnings. If an entity contemplates paying a dividend in excess of its retained earnings, it should first consult with legal counsel to ensure that it is permitted to do so.

US GAAP does not specifically address the accounting for dividends that exceed retained earnings and there is diversity in practice. For example, some entities record the dividends by increasing accumulated deficit, while others record such dividends as a reduction in APIC.



Question 5.6.30

Does an entity account for a modification or exchange of an equity-classified instrument as a dividend?

Interpretive response: It depends. The applicable accounting guidance for modifications or exchanges of equity-classified instruments depends on the type of instrument, as summarized in the following table.

Instrument	Accounting guidance
Common shares	<p>When common shares are modified or exchanged, it is typically in connection with a capital restructuring. In that case, all common shareholders typically give up or receive specific rights.</p> <p>In these circumstances, if there is no value being transferred from one class of shareholders to another, there will typically be no accounting effect. In contrast, if value is being transferred from one class of shareholders to another class (e.g. from common to preferred shareholders), the transfer of value may represent a dividend.</p>
Preferred shares	Section 5.4.60 discusses whether to account for a modification or exchange of a preferred share as an extinguishment (or as a modification), including whether a dividend is recognized.
Equity-classified warrants	The accounting depends on the nature of the modification or exchange. When the nature of a modification or exchange of an equity-classified warrant (that is in the scope of paragraphs

Instrument	Accounting guidance
	815-40-35-14 to 35-17) does not represent a financing and is not in the scope of another Topic, it is accounted for as a deemed dividend. Section 8.13.40 discusses determining the nature of the modification or exchange and how to measure and recognize its effect, including when it is accounted for as other than a deemed dividend.

5.6.20 Dividends on preferred shares

Preferred shares typically have stated dividends payable at specified times. The stated dividends can have special features – e.g. they can be cumulative or variable-rate.

Cumulative dividends	Preferred dividends are often cumulative, meaning that if the stated dividends are not paid when due, they must be paid in the future before common shareholders receive dividends.
Participating preferred shares	Preferred shares may have participating features that permit the holder to share with common shareholders in distributions beyond the preferred shares' stated dividend rate. Participating preferred shares may be fully or partially participating. Such features create complexity in computing EPS; see section 5.2 of KPMG Handbook, Earnings per share .
Variable-rate dividends	Preferred shares can have a variable-rate dividend if their dividend is indexed to an interest rate index or increases over a period of time or upon the occurrence of an event outside of the reporting entity's control. Variable-rate dividends are typically calculated based on an index such as an interest rate index (e.g. SOFR) or based on a specified formula. Other variable-rate dividends are based on the issuer's financial performance.

See also section 5.4.40 regarding increasing-rate dividends on preferred shares.



Question 5.6.40

When are cumulative dividends on preferred shares recognized?

Interpretive response: An entity records a liability for dividends on preferred shares (including cumulative dividends on preferred shares) when it incurs that liability – i.e. when the board of directors declares the dividend (see Question 5.6.10). [TPA 4210.04]

Often, an entity must declare and pay unpaid cumulative dividends on its preferred shares plus current year dividends on its preferred shares before it can pay dividends on its common shares. If the entity does not declare a dividend on the cumulative preferred shares, the dividends are in arrears.

Although the dividends are cumulative, they do not represent a liability until the board of directors declares the dividend. [TPA 4210.04]

An entity discloses in its financial statements (either on the face of the balance sheet or in the notes) the aggregate and per-share amounts of dividends in arrears on cumulative preferred shares. [505-10-50-5(b)]

Recognition of dividends on preferred shares that are classified as a liability or in temporary (instead of permanent) equity may differ from the above (see chapters 6 and 7, respectively). For example, an entity may be required to recognize deemed dividends prior to the declaration date for preferred shares that are classified in temporary equity and that are currently redeemable or for which redemption is probable, as further discussed in section 7.4. See also KPMG Handbook, [Earnings per share](#), for discussion of the EPS treatment of such deemed dividends (e.g. see section 3.3.20).



Question 5.6.50

How are dividends on preferred shares presented?

Interpretive response: The presentation of preferred share dividends depends on the classification of those shares as follows:



Dividends on liability-classified preferred shares are presented separately from interest due and payments to other creditors in the income statement and the statement of cash flows when the entity has no outstanding equity-classified instruments. [480-10-45-2]

Further, the aggregate and per-share amounts of dividends in arrears on cumulative preferred shares are presented either on the face of the balance sheet or in the notes. [505-10-50-5]



Question 5.6.60

How are a subsidiary's preferred dividends classified in the consolidated financial statements?

Interpretive response: The dividends on a subsidiary's preferred shares are included in the income allocation to NCI as a charge against income in the

consolidated financial statements. This is the case whether or not the shares are mandatorily redeemable. [810-10-40-2]

5.6.30 PIK dividends

An entity may pay noncash dividends to shareholders, including by transferring the following.

- **Equity instruments.** Such dividends are generally measured based on the fair value of the instruments issued at the date the dividend is declared. However, when convertible preferred shares require payment of dividends through issuing equity shares and certain other conditions are met, it is acceptable to measure dividends differently; see Question 10.5.40.
- **Assets other than cash.** Entities that have a large number of shareholders usually do not distribute assets as PIK dividends because of the complexity of distributing assets in proportion to each shareholder's interest in the entity.

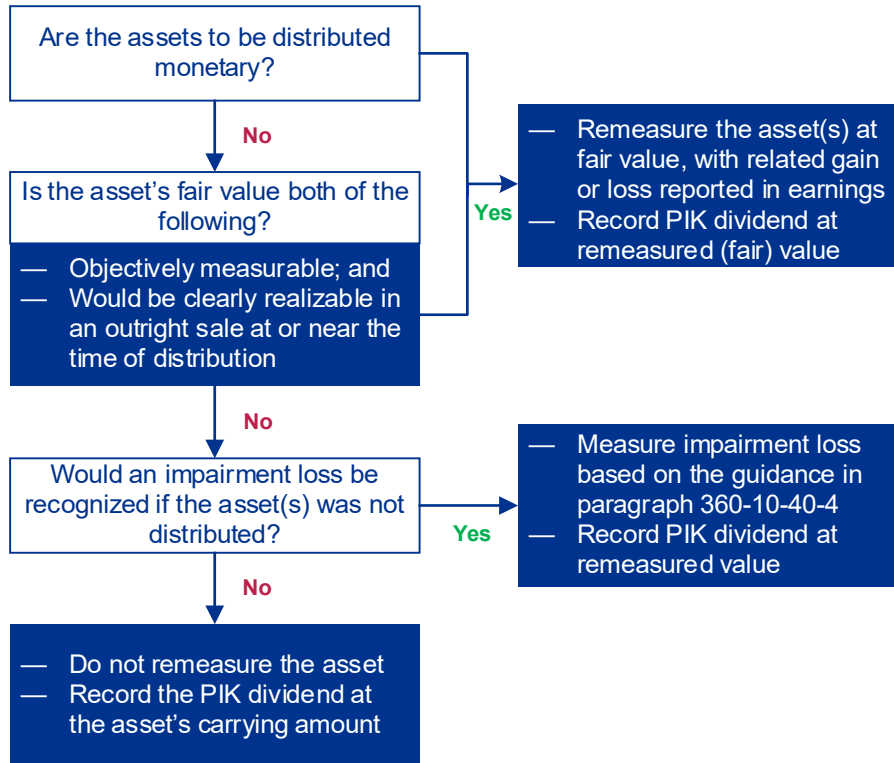
If an entity can pay dividends on convertible preferred shares by issuing common shares, it follows the guidance in Topic 505 (equity) when determining whether to account for a dividend as a stock dividend (i.e. reclassify retained earnings to the category of capital stock and APIC) or a stock split (i.e. no need to recapitalize retained earnings).



Question 5.6.70

How are assets transferred as PIK dividends accounted for?

Interpretive response: Like cash dividends, PIK dividends are recorded on their declaration date (see Question 5.6.10). Generally, as of that date, an entity remeasures the asset(s) to be distributed at fair value and records the PIK dividend at that fair value. The remeasurement of the asset to be distributed results in a gain or loss that is recognized in earnings. However, when the distribution involves nonmonetary assets, additional considerations apply, as summarized in the following decision tree. However, an entity should evaluate the scope exceptions of Topic 845 before applying the guidance above. [845-10-30-10]



Further, certain distributions of assets to shareholders are not (and are not accounted for as) PIK dividends (see Question 5.6.80).



Question 5.6.80

Is a spinoff or similar transaction a PIK dividend?

Interpretive response: No. Dividend distributions based on the following transactions are not PIK dividends. [845-10-30-10, 360-10-40-4]

- A spinoff. A pro rata distribution is the equivalent of a spinoff if it involves a distribution of any of the following types of shares:
 - shares of a subsidiary;
 - shares of any other investee entity that has been or is being consolidated; or
 - shares of an equity method investee.
- Another form of reorganization or liquidation.
- In a plan that is in substance the rescission of a prior business combination.

The guidance in Subtopic 505-60 (see section 5.9) applies to such transactions. Under that guidance, these transactions are accounted for based on the carrying amount of the assets to be distributed (instead of fair value). However, similar to the guidance for PIK dividends of nonmonetary assets (see Question 5.6.70), an entity cannot avoid recognizing and disclosing an indicated

impairment of value by distributing assets. Instead, the assets' carrying amount is reduced by the impairment before recording the transaction.



Example 5.6.20

Distribution of building as PIK dividend

On July 25, Year 1, Issuer's board of directors declares a PIK dividend in which Issuer will distribute a building with a fair value of \$1.5 million and carrying amount of \$1 million to existing shareholders. On that date, there are 100,000 ABC common shares outstanding.

The following are the key dates (Year 1):

- July 25: declaration date
- August 1: record date
- August 25: payment date (distribution is made)

The PIK dividend becomes a liability on July 25, the declaration date. Issuer records the following journal entries on that date.

	<i>Debit</i>	<i>Credit</i>
Building	500,000	
Gain on distribution of building to shareholders ¹ <i>To recognize gain on building to be distributed in PIK dividend.</i>		500,000
Retained earnings	1,500,000	
Dividend payable ² <i>To recognize PIK dividend.</i>		1,500,000
Notes:		
1. Fair value of building (\$1.5 million) – Carrying amount of building (\$1 million).		
2. PIK dividend is recognized for the fair value of the building.		

When the building is distributed on August 25, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Dividend payable	1,500,000	
Building <i>To recognize payment of PIK dividend.</i>		1,500,000

5.7 Stock dividends and stock splits

5.7.10 Overview



Excerpt from ASC 505-20

20 Glossary

Stock Dividend

An issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property that the board of directors deems necessary or desirable to retain in the business. A stock dividend takes nothing from the property of the corporation and adds nothing to the interests of the stockholders; that is, the corporation's property is not diminished and the interests of the stockholders are not increased. The proportional interest of each shareholder remains the same.

Stock Split

An issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares. Sometimes called a stock split-up.

05-2 Many recipients of stock dividends look upon them as distributions of corporate earnings, and usually in an amount equivalent to the **fair value** of the additional shares received. If the issuances of stock dividends are so small in comparison with the shares previously outstanding, such issuances generally do not have any apparent effect on the share market price and, consequently, the fair value of the shares previously held remains substantially unchanged.

05-4 If there is an increase in the fair value of a recipient's holdings, such unrealized appreciation is not income. In the case of a **stock dividend or stock split**, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his or her proportionate interest in the corporation.

05-5 See paragraph 260-10-55-12 for earnings per share (EPS) guidance if the number of common shares outstanding increases as a result of a stock dividend or stock split.

> Entities

15-1 The guidance in this Subtopic applies to all entities that are corporations.

> Transactions

15-2 The guidance in this Subtopic applies to all **stock dividends** and stock splits, with specific exceptions noted in paragraphs 505-20-15-3 through 15-3A.

15-3 The guidance in this Subtopic does not apply to the accounting for a distribution or issuance to shareholders of any of the following:

- a. Shares of another corporation held as an investment
- b. Shares of a different class
- c. Rights to subscribe for additional shares
- d. Shares of the same class in cases in which each shareholder is given an election to receive cash or shares.

15-3A Item (d) in the preceding paragraph includes, but is not limited to, a distribution having both of the following characteristics:

- a. The shareholder has the ability to elect to receive the shareholder's entire distribution in cash or shares of equivalent value.
- b. There is a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate.

For guidance on recognition of an entity's commitment to make a distribution described in the preceding paragraph, see paragraph 480-10-25-14. For guidance on computation of diluted EPS of an entity's commitment to make such a distribution, see the guidance in paragraphs 260-10-45-45 through 45-47.

Distributing shares to existing common shareholders can take the form of either a stock dividend or a stock split. Neither type of distribution changes an entity's total equity or any shareholder's interest in the entity. However, they are done for different reasons. Typically, stock dividends are issued to permanently capitalize a portion of retained earnings or to return a portion of profits to shareholders. In contrast, stock splits are typically issued to affect the market price of the entity's shares. It is important to identify whether a distribution of common shares is a stock dividend or a stock split because they are accounted for differently. [505-20 Glossary]

5.7.20 Distinguishing between a common stock dividend and common stock split



Excerpt from ASC 505-20

> Criteria for Treatment as Stock Dividend or Stock Split

25-1 This Section provides guidance on determining whether stock dividends and stock splits are to be accounted for in accordance with their actual form or whether their substance requires different accounting.

> Stock Dividend in Form

25-2 The number of additional shares issued as a **stock dividend** may be so great that it has, or may reasonably be expected to have, the effect of materially reducing the share market value. In such a situation, because the implications and possible shareholder belief discussed in paragraph 505-20-30-3 are not likely to exist, the substance of the transaction is clearly that of a **stock split**.

25-3 The point at which the relative size of the additional shares issued becomes large enough to materially influence the unit market price of the stock will vary with individual entities and under differing market conditions and, therefore, no single percentage can be established as a standard for determining when capitalization of retained earnings in excess of legal requirements is called for and when it is not. Except for a few instances, the issuance of additional shares of less than 20 or 25 percent of the number of previously outstanding shares would call for treatment as a stock dividend as described in paragraph 505-20-30-3.

> Stock Split in Form

25-4 A stock split is confined to transactions involving the issuance of shares, without consideration to the corporation, for the purpose of effecting a reduction in the unit market price of shares of the class issued and, therefore, of obtaining wider distribution and improved marketability of the shares.

25-5 Few cases will arise in which the aforementioned purpose can be accomplished through an issuance of shares that is less than 20 or 25 percent of the previously outstanding shares.

25-6 The corporation's representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it shall be recorded as a stock dividend or a stock split. Nevertheless, the issuance of new shares in ratios of less than 20 or 25 percent of the previously outstanding shares, or the frequent recurrence of issuances of shares, would destroy the presumption that transactions represented to be stock splits shall be recorded as stock splits.

50-1 Paragraph 505-20-25-2 identifies a situation in which a stock dividend in form is a stock split in substance. In such instances every effort shall be made to avoid the use of the word dividend in related corporate resolutions, notices, and announcements and that, in those cases in which because of legal requirements this cannot be done, the transaction be described, for example, as a stock split effected in the form of a dividend.

The difference between a stock dividend and a stock split is based on the size of the common stock distribution to shareholders, and not the form of the distribution. [505-20-25-3, 30-3]

- **Stock split.** A stock distribution is treated as a stock split if the number of shares issued is so great that it may significantly reduce the per-share market value of the stock. This is generally the case when a stock distribution is greater than 20% to 25% of shares outstanding before the distribution.

- **Stock dividend.** A stock distribution of less than 20% to 25% of shares outstanding before the dividend is generally considered a stock dividend. Although it is presumed that a small stock dividend has no significant effect on share price, an entity considers the dilutive effect of the additional shares in the determination of the per share fair value of the dividend.

If a common stock distribution is a stock split, the entity cannot describe it as a dividend in related documents – e.g. corporate resolutions, notices, announcements. Subtopic 505-20 does make an exception when an entity is legally required to call a stock split a dividend in a public document. However, in that case, the entity needs to describe the distribution in a manner that makes clear that the distribution of common shares is not a stock dividend – e.g. ‘a stock split effected in the form of a dividend’. [505-20-50-1]



Example 5.7.10 Large common stock dividend

Issuer declares a common stock dividend in which it issues one additional common share to existing shareholders for every two common shares they currently own. Before the stock dividend, Issuer has 1 million common shares outstanding. Therefore, it issues 500,000 additional common shares as the stock dividend.

By issuing the common stock dividend, Issuer increases the number of common shares outstanding by 50%. Therefore, it considers the dividend to be a stock split. Section 5.7.40 discusses how to account for a stock split.



Question 5.7.10 Does the SEC have guidance on how to distinguish between a stock dividend and a stock split?



Financial Reporting Release 214

Pro Rata Distributions to Shareholders

Several instances had come to the attention of the Commission in which registrants made pro rata stock distributions which were misleading. These situations arise particularly when a registrant makes distributions at a time when its retained earnings or its current earnings are substantially less than the fair value of the shares distributed. Under present GAAP, if the ratio of distribution is less than 25 percent of shares of the same class outstanding, the fair value of the shares issued must be transferred from retained earnings to other capital accounts. Failure to make this transfer in connection with a distribution or making a distribution in the absence of retained or current earnings is evidence of a misleading practice. Distributions of over 25 percent (which do not normally call for transfers of fair value) may also lend themselves

to such an interpretation if they appear to be part of a program of recurring distributions designed to mislead shareholders.

It has long been recognized that no income accrues to the shareholder as a result of such stock distributions or dividends, nor is there any change in either the corporate assets or the shareholders' interests therein. However, it is also recognized that many recipients of such stock distributions, which are called or otherwise characterized as dividends, consider them to be distributions of corporate earnings equivalent to the fair value of the additional shares received. In recognition of these circumstances, the AICPA has specified in ARB 43, Chapter 7, paragraph 10, that "... the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions."

The Commission also considers that if such stock distributions are not accounted for in this manner, the shareholders may be misled. In a stop order proceeding,* the Commission found that a registration statement was materially misleading because a series of four stock distributions made between 1966 and 1968 "... were 'part of a frequent recurrence of issuances of shares' ... [and] ... under generally accepted accounting principles they should have been accounted for as stock dividends."

* *Monmouth Capital Corporation*, Securities Act Release No. 5169 (July 14, 1971)

Interpretive response: Yes. SEC registrants consider SEC Financial Reporting Release 214 when making pro rata stock distributions to common shareholders. FR-214 looks to the pattern of distributions to determine the appropriate accounting.

Under that guidance, a stock dividend of less than 25% of the same class of common stock generally is accounted for as a stock dividend. However, it may be appropriate for distributions of greater than 25% to be accounted for as a stock dividend if they appear to be part of a program of recurring distributions. This is because stock dividends generally result in a charge to retained earnings while stock splits do not, so accounting for recurring distributions as stock splits might be misleading to shareholders. [\[FR-214\]](#)

**Question 5.7.20****Are free distributions by Japanese companies of less than 25% of outstanding common stock accounted for as stock dividends or stock splits?****Excerpt from SAB Topic 1.D.2****"Free Distributions" by Japanese Companies**

Facts: It is the general practice in Japan for corporations to issue "free distributions" of common stock to existing shareholders in conjunction with offerings of common stock so that such offerings may be made at less than market. These free distributions usually are from 5 to 10 percent of outstanding stock and are accounted for in accordance with provisions of the Commercial Code of Japan by a transfer of the par value of the stock distributed from paid-in capital to the common stock account. Similar distributions are sometimes made at times other than when offering new stock and are also designated "free distributions." U.S. accounting practice would require that the fair value of such shares, if issued by U.S. companies, be transferred from retained earnings to the appropriate capital accounts.

Question: Should the financial statements of Japanese corporations included in Commission filings which are stated to be prepared in accordance with U.S. GAAP be adjusted to account for stock distributions of less than 25 percent of outstanding stock by transferring the fair value of such stock from retained earnings to appropriate capital accounts?

Interpretive Response: If registrants and their independent accountants believe that the institutional and economic environment in Japan with respect to the registrant is sufficiently different that U.S. accounting principles for stock dividends should not apply to free distributions, the staff will not object to such distributions being accounted for at par value in accordance with Japanese practice.

If such financial statements are identified as being prepared in accordance with U.S. GAAP, then there should be footnote disclosure of the method being used which indicates that U.S. companies issuing shares in comparable amounts would be required to account for them as stock dividends, and including in such disclosure the fair value of any such shares issued during the year and the cumulative amount (either in an aggregate figure or a listing of the amounts by year) of the fair value of shares issued over time.

Interpretive response: It depends. Under US GAAP, such a free distribution of common shares is ordinarily treated as a stock dividend. However, the SEC staff will not object to such a distribution being treated as a stock split if the entity and its auditors determine that the institutional and economic environment in Japan is sufficiently different that the stock dividend requirements under US GAAP should not apply. Accounting for such a free distribution as a stock split is consistent with the accounting treatment under Japanese law. [SAB Topic 1.D.2]

When an entity accounts for such a free distribution as a stock split, the entity discloses: [SAB Topic 1.D.2]

- the method it is using – i.e. transferring the common shares' par value from paid-in capital to a share account;
 - the accounting treatment that would apply under US GAAP – i.e. transferring the common shares' fair value from retained earnings to a capital account;
 - the value of the common shares issued during the year through a free distribution; and
 - the cumulative amount of the fair value of common shares issued over time (either in the aggregate or by year).
-

5.7.30 Common stock dividends



Excerpt from ASC 505-20

> Issuer's Accounting for a Stock Dividend or Stock Split

30-2 Section 505-20-25 provides guidance on determining whether a stock dividend or a stock split shall be accounted for according to its form or whether it shall be accounted for differently. The following guidance addresses the accounting for the substantive nature of the transaction as either a stock dividend or a stock split.

• > Stock Dividend

30-3 In accounting for a stock dividend, the corporation shall transfer from retained earnings to the category of capital stock and additional paid-in capital an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings that the shareholder may believe to have been distributed to him or her will be left, except to the extent otherwise dictated by legal requirements, in retained earnings subject to possible further similar stock issuances or cash distributions.

30-4 The accounting required in the preceding paragraph will likely result in the capitalization of retained earnings in an amount in excess of that called for by the laws of the state of incorporation; such laws generally require the capitalization only of the par value of the shares issued, or, in the case of shares without par value, an amount usually within the discretion of the board of directors. However, these legal requirements are, in effect, minimum requirements and do not prevent the capitalization of a larger amount per share.

• • > Alternative Treatment Permitted for Closely Held Entity

30-5 In cases of closely held entities, it is presumed that the intimate knowledge of the corporations' affairs possessed by their shareholders would preclude any implications and possible shareholder belief as are referred to in paragraph 505-20-30-3. In such cases, there is no need to capitalize retained earnings other than to meet legal requirements.

An entity accounts for a stock dividend by transferring the fair value of the common shares issued from retained earnings to the appropriate category of common shares and APIC. [505-20-30-3]



Question 5.7.30

How is a stock dividend accounted for when the retained earnings account has an accumulated deficit?

Interpretive response: If retained earnings is in a deficit position, stock dividends payable to common shareholders are accounted for by capitalizing only the share's par value – instead of its fair value – as an adjustment to APIC. This accounting treatment is similar to the accounting treatment for a stock split (see section 5.7.40). [CAQ 03/2001]

To pay a dividend in this circumstance, an entity needs to have sufficient APIC from which to pay the dividend and should consult with legal counsel to determine whether it is precluded from issuing a dividend when it has an accumulated deficit. [505-20-30-3 – 30-4]



Example 5.7.20

Small common stock dividend

Issuer declares a stock dividend in which it issues one additional common share to existing common shareholders for every 1,000 common shares they currently own. Before the stock dividend, Issuer has 10 million common shares outstanding. Therefore, it issues 10,000 additional common shares. Issuer common shares have a par value of \$1 per share and a fair value of \$50 per share.

Given the small size of the dividend relative to the total number of common shares outstanding (0.1%), Issuer does not expect the stock dividend to have any consequential effect on the market price of its common shares. Therefore, Issuer concludes the distribution is a stock dividend instead of a stock split.

The par value of the common shares is not changed in connection with the stock dividend.

Scenario 1: Issuer has positive retained earnings

Issuer records the following journal entry on the declaration date.

	<i>Debit</i>	<i>Credit</i>
Retained earnings ¹	500,000	
Common shares – par value ²		10,000
APIC ³		490,000
<i>To recognize small stock dividend.</i>		

Notes:

1. 10,000 shares issued × \$50 fair value per share.
2. 10,000 shares issued × \$1 par value per share.
3. Fair value of shares issued (10,000 shares issued × \$50 fair value per share) – 'Common shares – Par value'.

Scenario 2: Issuer has accumulated deficit (i.e. negative retained earnings)

Assume Issuer has sufficient APIC from which to pay the dividend and has consulted with legal counsel in determining that it is not precluded from issuing a dividend.

Issuer records the following journal entry on the declaration date.

	<i>Debit</i>	<i>Credit</i>
APIC	10,000	
Common shares – par value ¹		10,000
<i>To recognize small stock dividend.</i>		
Note:		
1. 10,000 shares issued × \$1 par value per share.		



Question 5.7.40

How is a stock dividend accounted for when the shares distributed are another class of shares?

Interpretive response: When an entity pays a stock dividend on common shares with a different class of shares (e.g. preferred shares or a different class of common shares), it reduces retained earnings by the fair value of the securities it intends to issue with a corresponding increase in the appropriate class of shares issued. Such a transaction does not represent a stock split, regardless of the number of shares issued. [505-20-30-3 – 30-4]



Question 5.7.50

How is a stock dividend accounted for when the shares distributed are treasury shares?

Interpretive response: An entity accounts for a stock dividend paid by issuing treasury shares in the same manner as a stock dividend not involving treasury shares, meaning that retained earnings is reduced for the fair value of the common shares. [505-20-30-3 – 30-4]

Section 5.8 discusses treasury share transactions, including when shares are reissued from treasury shares. In particular, see Examples 5.8.10 and 5.8.20.



Question 5.7.60

Are consolidated retained earnings affected when a wholly owned subsidiary declares a stock dividend to its parent?

Interpretive response: No. When a subsidiary issues a stock dividend to its parent, retained earnings are not transferred in the consolidation process. This is because the consolidated retained earnings reflects the accumulated earnings of the consolidated group not distributed to the parent's owners, or capitalized by, the parent. [810-10-45-9]

5.7.40 Common stock splits and reverse common stock splits



Excerpt from ASC 505-20

- > Stock Split

30-6 In the case of a stock split, there is no need to capitalize retained earnings, other than to the extent occasioned by legal requirements.

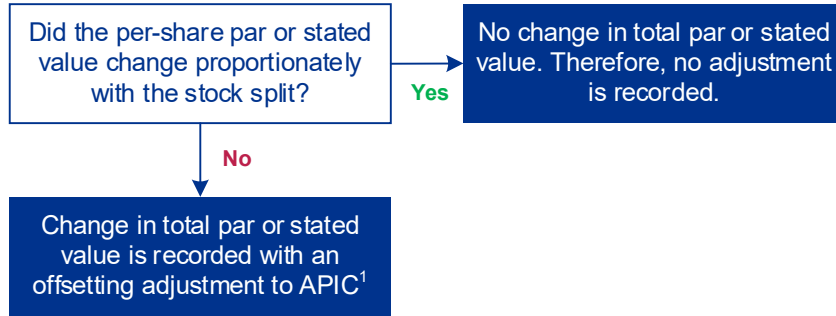
In a common stock split, shareholders receive additional common shares based on their relative ownership percentage in the entity. Typically, the purpose of a common stock split is to reduce the price per common share. In contrast, in a reverse stock split, common shareholders receive fewer common shares in exchange for their existing common shares. For example, they may receive one new common share for every three existing common shares. Typically, the purpose of a reverse stock split is to increase the price per common share.



Question 5.7.70

How is a common stock split recorded?

Interpretive response: It depends. Because a stock split usually results in the per-share par or stated value being adjusted proportionately, it does not affect the total par value of the common shares and no adjustment is recorded. However, an adjustment is necessary if the total par or stated value (if any) of the outstanding common shares has changed due to the split because of legal or other reasons. [505-20-30-6]



1. If the entity does not have APIC, the offsetting adjustment is recorded to retained earnings.



Example 5.7.30 Common stock split

Issuer has 100 common shares outstanding with a par value of \$1 per share. It declares a 2-for-1 stock split and issues one common share to existing shareholders for each common share they currently own – i.e. it issued a total of 100 common shares in the split.

The market price of the common shares was \$50 per share before the split. Therefore, the price per common share would likely decrease to approximately \$25 after the split because of the additional shares outstanding.

Scenario 1: Par value is changed to \$0.50 per share

Issuer does not record a journal entry. This is because the per-share par value changed proportionately with the split, resulting in the total par value of outstanding common shares after the split being equal to the total par value before the split.

Shares outstanding	Par value per share	Total par value
Before split		
100 common shares	\$1 per share	\$100
After split		
200 common shares	\$0.50 per share	\$100

Scenario 2: Par value is not changed (it remains \$1 per share)

In this scenario, state law requires that a corporation’s common shares have a par value of \$1 or greater. As a result, the par value remains \$1 per share after the split.

Issuer compares the total par value of its outstanding common shares before and after the split.

Shares outstanding	Par value per share	Total par value
Before split		
100 common shares	\$1 per share	\$100
After split		
200 common shares	\$1 per share	\$200

Issuer records the following journal entry on the declaration date to reflect the increase in total par value.

	<i>Debit</i>	<i>Credit</i>
APIC ¹	100	
Common shares ²		100
<i>To recognize 2-for-1 stock split.</i>		
Notes:		
1. If Issuer did not have a sufficient APIC balance, it would decrease retained earnings instead of APIC.		
2. \$200 total par value after stock split – \$100 total par value before stock split.		



Example 5.7.40 Reverse common stock split

Issuer declares a 1-for-10 reverse common stock split and issues one common share to existing shareholders for every 10 common shares they currently own.

The reduction in the number of common shares outstanding is expected to increase the market price per common share by a factor of approximately 10. Therefore, if the market price was \$10 per share before the reverse common stock split, it would likely increase to approximately \$100 per share after the reverse common stock split because of the reduction in the number of common shares outstanding.

If the par value per share increases proportionately with the reverse common stock split, Issuer would not record any journal entry to reflect the reverse common stock split.

5.7.50 Retroactive effect of common stock dividends, common stock splits and reverse common stock splits



Excerpt from SAB Topic 4.C

Changes in Capital Structure

Facts: A capital structure change to a stock dividend, stock split or reverse split occurs after the date of the latest reported balance sheet but before the release of the financial statements or the effective date of the registration statement, whichever is later.

Question: What effect must be given to such a change?

Interpretive Response: Such changes in the capital structure must be given retroactive effect in the balance sheet.

An appropriately cross-referenced note should disclose the retroactive treatment, explain the change made and state the date the change became effective.

When an equity restructuring (e.g. common stock dividends, common stock splits, reverse common stock splits) occurs, EPS is retrospectively adjusted for all periods presented. This approach applies regardless of whether the event occurs during the reporting period or after the reporting date but before the financial statements are issued (or effective date of a registration statement). Similarly, dividends per share are retrospectively adjusted for all periods presented. Section 7.3.10 of KPMG Handbook, [Earnings per share](#), discusses the EPS implications. [260-10-55-12, SAB Topic 4.C]

Further, if the effective date of an equity restructuring is after the reporting date, but before the release of the financial statements (or effective date of its registration statement), the entity retroactively adjusts its balance sheet for the stock dividend or stock split when it issues the financial statements.

[SAB Topic 4.C]



Question 5.7.80

How are a balance sheet and statement of shareholders' equity adjusted for the effects of a common stock dividend, common stock split or reverse common stock split?

Interpretive response: In some situations, no adjustment is needed to the balance sheet or statement of shareholders' equity – e.g. when the total par value of shares outstanding does not change as the result of a stock split (see Question 5.7.70). However, when adjustment is needed, we believe an entity may make an accounting policy election (applied consistently) to present the adjustment in one of the following ways:

- adjust all periods presented; or
- present the adjustment only in the current-year balance sheet and equity statement.

When an entity retroactively reflects a change in capital structure, it discloses the retroactive treatment, explains the change made, and states the date the change became effective. Changes in numbers of common shares issued and outstanding throughout a document filed with the SEC should clearly reconcile to various financial statement notes that incorporate stock-related data. [SAB Topic 4.C]



Question 5.7.90

If a common stock dividend, common stock split or reverse common stock split occurs after the reporting date, what is the trigger date for retrospectively adjusting the financial statements?

Interpretive response: Question 5.7.80 addresses that EPS is retrospectively adjusted for all periods presented when an equity restructuring occurs and Question 5.6.10 addresses key dates relating to dividends. For determining at what date retroactive restatement is required, we believe a post-balance sheet date common stock dividend, common stock split or reverse common stock split occurs on the ex-dividend date.

The ex-dividend date is the date on which the shares start trading without the value of the next dividend payment (see Question 5.6.10). On this date:

- the entity knows the quantity of common shares affected by the event; and
- the market reflects the adjusted per-share price.

As a result, an entity typically reflects retrospective adjustment when the ex-dividend date is before the release of the financial statements or the effective date of the registration statement.

For distributions greater than 25%, the record date comes before the ex-dividend date. Because the quantity of common shares and who will receive them is known on the record date in this case, we believe the SEC staff would not object to using the record date as the trigger date for greater than 25% distributions.

However, we believe an entity may not make such retrospective adjustment if the transaction requires approval that is outside the entity's control (e.g. regulatory approval).

If the effective date of the stock dividend or stock split is after the issuance of the financial statements and the entity does not retrospectively adjust the financial statements, the entity may provide pro forma disclosure in the notes to its financial statements.

See further discussion in section 7.3 of KPMG Handbook, [Earnings per share](#).

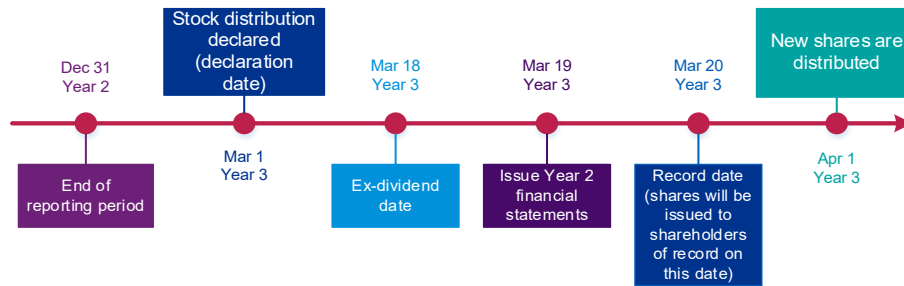


Example 5.7.50

Common stock distribution after reporting date

Issuer has a calendar year-end and declares a common stock distribution after the reporting date.

Issuer has the following timeline:



The trigger date for retrospectively adjusting the common stock distribution is on the ex-dividend date of March 18, Year 3. That is the date Issuer knows the quantity of common shares affected by the split and the market reflects the adjusted per-share price. That is the date that retrospective adjustment is required if the previous financial statements have not yet been issued.



Example 5.7.60

Common stock split in connection with an IPO

In February Year 4, Issuer files a registration statement on Form S-1 to register common shares for an IPO. Included in Form S-1 are Issuer's historical balance sheets as of December 31, Year 3 and Year 2 and historical income statements for each year in the three-year period ended December 31, Year 3. Further, in February Year 4, Issuer's board of directors approves a 2-for-1 stock split of common shares that will occur when the SEC declares the registration statement effective.

Issuer retrospectively adjusts the historical financial statements included in the registration statement for all periods presented to report the effect of the 2-for-1 stock split. Reporting the stock split in the historical financial statements in the registration statement is appropriate because Issuer will adjust the number of common shares issued in the IPO for the stock split, which affects the ownership share for new investors buying in to the IPO.

Because Issuer retroactively reflected the stock split in the historical financial statements, but the stock split has not yet occurred, the registration statement should include an unsigned 'draft audit report' with a legend indicating that the independent registered public accounting firm will be in a position to issue its report when the transaction referred to in the registration statement has been consummated (at effectiveness). [FRM 4710]



Question 5.7.100

Is the five-year table in a predecessor's financial statements in a registration statement retroactively required to reflect a common stock split that occurs after an IPO?

Background: SAB Topic 4.C indicates that a change in capital structure must be given retroactive effect for the periods presented and should be prominently disclosed. However, it does not clarify whether the periods presented are specific to the periods presented for an individual entity or for all periods presented inclusive of historical summary tables, which might include a predecessor entity. [\[SAB Topic 4.C\]](#)

Interpretive response: It depends. The new entity arising from the IPO (the Newco) analyzes its capital structure before and after the IPO. Newco retrospectively adjusts its five-year table in its financial statements if doing so meaningfully affects the comparability of its capital structure, per-share data, etc. [\[SAB Topic 4.C\]](#)

However, if retrospectively adjusting its financial statements would not meaningfully affect the comparability of its capital structure, per-share data, etc., it discloses in the notes to the five-year summary table in its registration statement that its share amounts and per-share data have not been adjusted to reflect the stock split. [\[SAB Topic 4.C\]](#)



Example 5.7.70

Financial statements in a registration statement retrospectively reflect a common stock split that occurs after an IPO

Newco is completing an IPO on Form S-1 and is the successor of Oldco. The registration statement includes financial statements of Newco as of December 31, Year 8 and Year 7. It also includes the related consolidated statements of operations, shareholders' deficit, comprehensive loss and cash flows for Years 6 to 8, which include Oldco's results following its acquisition on May 10, Year 6.

Before the May 10, Year 6 acquisition, Oldco was a publicly traded entity. The May 10, Year 6 transaction was effectively a leveraged acquisition of all outstanding public shares by an approximately 40% owner and resulted in Newco purchasing all outstanding shares. At the time of the acquisition, Newco was not a public company. Newco's Form S-1 includes summary historical consolidated financial data for a five-year period, including Newco for Years 6 to 8 and Oldco financial data for Years 4 and 5.

On November 29, Year 9, Newco's board of directors approves a 4-for-5 reverse stock split of Newco's common shares, reducing the outstanding common shares from 75.1 million shares to 60.1 million shares. The capital stock accounts, all share data and earnings (loss) per share, and stock options and corresponding exercise price give effect to the stock split, applied

retrospectively, to all periods presented. Newco has not applied retrospective presentation of the 4-for-5 reverse stock split to Oldco's financial statements.

Newco gave consideration to the comparability of its own and Oldco's capital structures. Oldco was a public company and a different legal entity that ultimately became a subsidiary of Newco via a leveraged buyout transaction, which significantly modified the capital structure. Newco determined that it has not modified these differences in the capital structures in any way that would aid in their comparability.

The retrospective adjustment of Newco's financial statements does not meaningfully affect the comparability of the capital structure, per-share data, etc. However, to ensure users of the financial data included in the registration statement are aware of the treatment of the stock split, Newco's registration statement discloses in the notes to the five-year summary table that: "Share amounts and per share data for Oldco have not been adjusted to reflect our four-for-five reverse stock split effective November 29, Year 9, because the capital structure of Newco is not comparable to Oldco."

5.8 Treasury shares

5.8.10 Overview



Excerpt from ASC 505-30

05-2 Entities may repurchase their own outstanding common stock for a variety of different purposes. Repurchased common stock is often referred to as treasury stock or treasury shares.

05-3 When entities repurchase their own common stock, laws applicable to those entities may affect the treatment and accounting for repurchased shares of stock. Entities sometimes pay more or less for the repurchased shares than either their **fair value** or their original issue price.

> Entities

15-1 The guidance in this Subtopic applies to all entities, unless more specific guidance for those transactions is provided in other Topics.

> Transactions

15-2 The guidance in this Subtopic applies to all transactions involving the repurchase of an entity's own outstanding common stock as well as the subsequent constructive or actual retirement of those shares, unless more specific guidance for those transactions is provided in other Topics.

25-1 This Section addresses the accounting requirements for the differences in amounts that result in either of the following situations:

- a. An entity repurchases its own outstanding common stock for an amount that differs from the price obtainable in open market transactions.
- b. An entity subsequently resells previously repurchased common stock for an amount that differs from the repurchase amount paid.

This Section also identifies a program to acquire treasury shares, often described as an accelerated share repurchase program, as two separate transactions.

25-2 Laws of some states govern the circumstances under which an entity may acquire its own stock and prescribe the accounting treatment therefor. If such requirements are at variance with the requirements of paragraphs 505-30-25-7 and 505-30-30-6 through 30-10, the accounting shall conform to the applicable law.

30-1 This Section provides guidance on measuring amounts that arise from repurchases of an entity's own outstanding common stock. The measurement issues addressed include both of the following:

- a. Determining the allocation of amounts paid to the repurchased shares and other elements of the repurchase transaction
- b. Further allocation of amounts allocated to repurchased shares to various components of stockholder equity upon formal or constructive retirement.

Treasury shares are an entity's common shares that the entity repurchases. Depending on state law, an entity can either immediately retire the shares or hold them. If state law does not require retirement upon repurchase, an entity may not immediately retire the repurchased shares, and it may reissue them or retire them in a future period. When treasury shares are retired, they are cancelled and therefore cease to exist.

An entity may repurchase its own common shares for several reasons, including:

- to counter the dilutive effect arising from employee compensation arrangements – e.g. granting stock options or issuing restricted stock for compensation purposes;
- to counter the dilutive effect arising from an acquisition in which the entity's shares will be issued as part of the purchase price; or
- to increase EPS by reducing the number of outstanding common shares.

Topic 505 applies to all transactions involving the repurchase of an entity's own outstanding common shares, including any subsequent retirement of repurchased shares, unless more specific guidance applies. More specific guidance includes the following. [\[505-30-15-1\]](#)

Transaction	Accounting guidance
Employer stock held by a rabbi trust	Paragraphs 710-10-25-15 to 25-18
Accounting when a sponsor repurchases ESOP shares from an employee	Paragraph 718-40-40-6
Clawback contingency provisions	Paragraph 718-10-55-8
Unallocated assets that consist of employer stock when an employer terminates a defined benefit plan and contributes the assets withdrawn to a defined contribution plan	Paragraph 715-70-55-8

**Question 5.8.05****Is a repurchase of preferred shares accounted for as a treasury shares transaction?**

Interpretive response: No. The treasury shares guidance in Subtopic 505-30 applies only to transactions involving common shares. Instead, an issuer accounts for a repurchase of its own preferred shares by recording any difference between the amount paid for the repurchase and the preferred stock's carrying amount in retained earnings as a deemed dividend (or contribution); see Question 5.4.35. [\[260-10-S99-2\]](#)

5.8.20 Repurchases of treasury shares**Excerpt from ASC 505-30**

> Allocating the Cost of Treasury Shares to Components of Shareholder Equity Upon Formal or Constructive Retirement

30-6 Once the cost of the treasury shares is determined under the requirements of this Section, and if a corporation's stock is acquired for purposes other than retirement (formal or constructive), or if ultimate disposition has not yet been decided, paragraph 505-30-45-1 permits the cost of acquired stock to either be shown separately as a deduction from the total of capital stock, additional paid-in capital, and retained earnings, or be accorded the following accounting treatment appropriate for retired stock.

45-1 If a corporation's stock is acquired for purposes other than retirement (formal or constructive), or if ultimate disposition has not yet been decided, the cost of acquired stock may be shown separately as a deduction from the total of capital stock, additional paid-in capital, and retained earnings, or may be accorded the accounting treatment appropriate for retired stock specified in paragraphs 505-30-30-7 through 30-10.

[See paragraphs 505-30-30-7 through 30-9 and paragraph 505-30-30-10 reproduced in sections 5.8.40 and 5.8.50, respectively]

**Question 5.8.10#****How are treasury shares recorded and presented?**

Interpretive response: The cost of treasury shares is recorded as a reduction of shareholder's equity. The cost can be shown separately as a deduction from the total of capital shares, APIC and retained earnings unless the repurchased shares are immediately retired (see section 5.8.40). In our experience, treasury shares are typically presented as a separate caption in equity – i.e. as a deduction from total equity. [\[505-30-30-6\]](#)

Based on this accounting, an entity does not record treasury shares as an asset. Further, the entity does not recognize dividends on the treasury shares as income under any circumstances because an entity cannot pay itself a dividend.



Question 5.8.20

Can direct and incremental costs of repurchasing treasury shares be added to their cost?

Interpretive response: Yes. Share issuance costs are deducted from proceeds of the issuance. Similarly, we believe an entity may add direct and incremental costs associated with acquiring treasury shares to their cost. Section 5.10 discusses costs relating to share issuance. [TPA 4110.09]



Question 5.8.30

Is a repurchase of equity-classified common shares from an employee accounted for similar to other repurchases of treasury shares?

Interpretive response: Generally, yes. However, Topic 718 provides guidance to be followed when shares are repurchased from an employee in certain situations, such as when: [718-10-25-9 – 25-10]

- the repurchase price (i.e. cash or other assets paid, or liabilities assumed) exceeds fair value; or
- shares are awarded to an employee as stock-based compensation and are later repurchased before the employee has been exposed to the risks and rewards of share ownership – generally shares owned for less than six months, also known as immature shares.

Further, a pattern of cash-settling awards may result in an entity classifying awards as liabilities, instead of equity.

See KPMG Handbook, [Share-based payment](#), including chapter 5 (modifications).

5.8.30 Allocation of repurchase amount to other elements of the transaction



Excerpt from ASC 505-30

> Requirement to Allocate Repurchase Amount

25-3 The facts and circumstances associated with a share repurchase may suggest that the total payment relates to other than the shares repurchased. An entity offering to repurchase shares only from a specific shareholder (or group of shareholders) suggests that the repurchase may involve more than

the purchase of treasury shares. Also, if an entity repurchases shares at a price that is different from the price obtainable in transactions in the open market or transactions in which the identity of the selling shareholder is not important, some portion of the amount being paid presumably represents a payment for stated or unstated rights or privileges that shall be given separate accounting recognition. See paragraph 505-30-30-3 for the measurement requirements associated with the different elements identified within such a transaction.

25-4 Payments by an entity to a shareholder or former shareholder attributed, for example, to a standstill agreement, or any agreement in which a shareholder or former shareholder agrees not to purchase additional shares, shall be expensed as incurred. Such payments do not give rise to assets of the entity.

> Allocating Repurchase Price to Other Elements of the Repurchase Transaction

30-2 An allocation of repurchase price to other elements of the repurchase transaction may be required if an entity purchases treasury shares at a stated price significantly in excess of the current market price of the shares. An agreement to repurchase shares from a shareholder may also involve the receipt or payment of consideration in exchange for stated or unstated rights or privileges that shall be identified to properly allocate the repurchase price.

30-3 For example, the selling shareholder may agree to abandon certain acquisition plans, forego other planned transactions, settle litigation, settle employment contracts, or restrict voluntarily the ability to purchase shares of the entity or its affiliates within a stated time period. If the purchase of treasury shares includes the receipt of stated or unstated rights, privileges, or agreements in addition to the capital stock, only the amount representing the fair value of the treasury shares at the date the major terms of the agreement to purchase the shares are reached shall be accounted for as the cost of the shares acquired. The price paid in excess of the amount accounted for as the cost of treasury shares shall be attributed to the other elements of the transaction and accounted for according to their substance. If the fair value of those other elements of the transaction is more clearly evident, for example, because an entity's shares are not publicly traded, that amount shall be assigned to those elements and the difference recorded as the cost of treasury shares. If no stated or unstated consideration in addition to the capital stock can be identified, the entire purchase price shall be accounted for as the cost of treasury shares.

30-4 Transactions do arise, however, in which a reacquisition of an entity's stock may take place at prices different from routine transactions in the open market. For example, to obtain the desired number of shares in a tender offer to all or most shareholders, the offer may need to be at a price in excess of the current market price. In addition, a block of shares representing a controlling interest will generally trade at a price in excess of market, and a large block of shares may trade at a price above or below the current market price depending on whether the buyer or seller initiates the transaction. An entity's reacquisition of its shares in those circumstances is solely a treasury stock transaction properly accounted for at the purchase price of the treasury shares. Therefore, in the absence of the receipt of stated or unstated consideration in

addition to the capital stock, the entire purchase price shall be accounted for as the cost of treasury shares.

> Disclosures Relating to Allocation of Repurchase Price

50-3 A repurchase of shares at a price significantly in excess of the current market price creates a presumption that the repurchase price includes amounts attributable to items other than the shares repurchased. A repurchase of shares at a price significantly in excess of the current market price may require an entity to allocate amounts to other elements of the transaction under the requirements of paragraph 505-30-30-2.

50-4 The allocation of amounts paid to the treasury shares and other elements of the transaction requires significant judgment and consideration of many factors that can significantly affect amounts recognized in the financial statements. Disclosure of the allocation of amounts and the accounting treatment for such amounts is necessary to enable the user of the financial statements to understand the nature of significant transactions that may affect, in part, the capital of the entity. The allocation of amounts paid and the accounting treatment for such amounts shall be disclosed.

A portion of the payment for certain common share repurchase transactions may relate to something other than the common shares repurchased. For example, this can occur when an entity offers to repurchase common shares only from a specific shareholder and provides an additional right to the shareholder. In these cases, part of the repurchase price is allocated to the other element if the repurchase price significantly exceeds the shares' current market price. [505-30-30-2]

When an entity repurchases treasury shares at a stated price significantly in excess of the current market price and allocates amounts to elements other than the common shares repurchased, an entity discloses: [505-30-50-4]

- the allocation of amounts paid; and
- the accounting treatment for such amounts.



Question 5.8.40

Is there always an additional element in a repurchase of common shares at an above-market price?

Interpretive response: No. An entity needs to identify why it is paying more than market price for its common shares that it repurchases. If it has to pay more to entice shareholders to sell their common shares, the repurchase price paid may be solely for treasury shares. Another instance in which an above-market price may relate solely to the repurchased share is the purchase of a controlling interest. [505-30-30-4]

Defending against a hostile takeover

A hostile takeover occurs when a party acquires an entity by obtaining its equity shares directly from the entity's shareholders instead of agreeing to a business combination with the board of directors and management. A hostile takeover can be accomplished through either a tender offer or a proxy fight. Costs of defending against an unwanted takeover are generally expensed, including when those costs involve treasury share transactions.



Question 5.8.50

How are costs to defend against a hostile takeover during the registration process accounted for?

Interpretive response: An entity expenses the costs incurred to protect against a hostile takeover during the IPO process instead of netting them against the subsequent proceeds from the IPO. Costs to defend against a hostile takeover attempt are discretionary in nature and are not part of the costs of raising capital in an IPO; this is because an entity can continue the offering without defending itself. Further, costs to defend against a hostile takeover attempt do not meet the definition of an asset in FASB Concepts Statement No. 8 (CON 8) because the entity does not obtain a particular economic benefit. [CON 8.E16]

Further, the SEC Observer at an EITF meeting stated that an entity should expense any amounts designated as or reasonably determinable to be expense reimbursements. This includes that a share repurchase price unreasonably in excess of the market price is evidence that the purchase price includes expense reimbursements and amounts reasonably determined to be expense reimbursements should be expensed instead of included in the cost to repurchase shares. By analogy, we believe the entity should expense any costs associated with defending against a takeover attempt regardless of whether it incurred such costs during the registration process or after it became a public entity. [EITF 85-2]



Question 5.8.60

How is a standstill agreement accounted for?

Background: To defend against an unwanted hostile takeover, an entity could repurchase some of its shares. Such repurchases for this purpose generally involve a standstill agreement under which the shareholder agrees to not purchase additional shares for a specified period.

Interpretive response: Costs associated with a standstill agreement are expensed. Therefore, when the stated or unstated consideration in a share repurchase transaction involves a standstill agreement or similar arrangement, the amount allocated to this provision is recorded as an expense as incurred. Payments in these types of arrangements do not represent an asset and

therefore are expensed even if the arrangement spans more than one accounting period. [505-30-25-3 – 25-4]



Question 5.8.70

How is a greenmail transaction accounted for?

Interpretive response: An entity that enters into a standstill agreement (see Question 5.8.60) may also agree to repurchase its shares from the shareholder at a later date, typically at a premium (referred to as a 'greenmail transaction').

In this situation, the entity separates the amount paid between: [505-30-30-2 – 30-4]

- the cost to repurchase its shares (i.e. fair value of shares on repurchase date), which represents a treasury share transaction; and
- the premium paid to repurchase shares, which is expensed as incurred.



Question 5.8.80

How is a poison pill accounted for?

Background: Some companies put into place shareholder rights plans to prevent unwanted hostile takeovers (referred to as 'poison pills'). While their terms vary, a common poison pill involves allowing existing shareholders to exercise their rights if certain events occur. For example, the rights under a rights plan may be triggered when a single shareholder has acquired beneficial ownership of the entity's shares exceeding a specified percentage. At that time, all other shareholders would be permitted to purchase shares at a price that is significantly less than the shares' fair value.

Interpretive response: The rights granted to existing shareholders are generally accounted for at issuance as a dividend that is measured at the fair value of those rights – i.e. when the shareholder rights plan is put into place. Unlike standstill agreements or greenmail transactions, which are generally individually negotiated arrangements with specified shareholders seeking the takeover, a rights plan applies to all outstanding shares. Therefore, we believe rights issued under such a plan represent a dividend instead of an expense.

5.8.40 Retirement of treasury shares



Excerpt from ASC 505-30

> Allocating the Cost of Treasury Shares to Components of Shareholder Equity Upon Formal or Constructive Retirement

30-5 An entity that repurchases its own outstanding common stock may be required under paragraph 505-30-30-3 to allocate a portion of the repurchase price to other elements of the transaction.

30-7 The difference between the cost of the treasury shares and the stated value of a corporation's common stock repurchased and retired, or repurchased for constructive retirement, shall be reflected in capital.

30-8 When a corporation's stock is retired, or repurchased for constructive retirement (with or without an intention to retire the stock formally in accordance with applicable laws), an excess of repurchase price over par or stated value may be allocated between additional paid-in capital and retained earnings. Alternatively, the excess may be charged entirely to retained earnings in recognition of the fact that a corporation can always capitalize or allocate retained earnings for such purposes. If a portion of the excess is allocated to additional paid-in capital, it shall be limited to the sum of both of the following:

- a. All additional paid-in capital arising from previous retirements and net gains on sales of treasury stock of the same issue
- b. The pro rata portion of additional paid-in capital, voluntary transfers of retained earnings, capitalization of stock dividends, and so forth, on the same issue. For this purpose, any remaining additional paid-in capital applicable to issues fully retired (formal or constructive) is deemed to be applicable pro rata to shares of common stock.

30-9 When a corporation's stock is retired, or repurchased for constructive retirement (with or without an intention to retire the stock formally in accordance with applicable laws), an excess of par or stated value over the cost of treasury shares shall be credited to additional paid-in capital.



Question 5.8.90

How is the retirement of treasury shares accounted for?

Interpretive response: It depends on whether the repurchase price of treasury shares exceeds the par or stated value of those shares.

Repurchase price exceeds par or stated value

If state law provides specific guidance on how an entity must account for repurchases of its own shares, the entity follows that guidance. If state law does not address the accounting for the repurchased common shares, one of the following methods may generally be used. The selection of a method represents an accounting policy, which is applied consistently. Further, the entity should consider disclosing the policy in its financial statements.

Method 1 (see Example 5.8.10)

Allocate the excess of the repurchase price over the par or stated value of the shares between APIC and retained earnings. The portion of the excess allocated to APIC is limited to the sum of: [505-30-30-8]

	<ul style="list-style-type: none"> — all APIC arising from previous retirements and net gains on sales of treasury shares of the same issue; and — the pro rata portion of APIC, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining APIC applicable to issues fully retired (formal or constructive) is deemed to apply pro rata to common shares.
Method 2	Charge the excess of the repurchase price over the par or stated value of the shares to retained earnings in recognition of the fact that an entity can always capitalize or allocate retained earnings for such purposes. [505-30-30-8]
Method 3	<p>Charge the excess of the repurchase price over the par or stated value of the shares to APIC, or to retained earnings once APIC is reduced to zero.</p> <p>This method is based on ARB 43, which stated that “apparently there is general agreement that the difference between the purchase price and the stated value of a corporation’s common shares purchased and retired should be reflected in capital surplus.” While this guidance was not migrated to the Codification, it is generally applied in practice. [ARB 43.7.7]</p> <p>The portion of the excess charged to APIC is limited to the sum of:</p> <ul style="list-style-type: none"> — all APIC arising from previous retirements and net gains on sales of treasury shares of the same issue; and — all APIC, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining APIC applicable to issues fully retired (formal or constructive) is deemed to be applicable to common shares.

Par or stated value exceeds repurchase price

APIC is credited for any excess of par or stated value over the repurchase price of treasury shares. [505-30-30-9]

 **Question 5.8.100**
How is the retirement of treasury shares accounted for if an entity does not report APIC?

Background: An entity’s common shares may have no par or stated value. In our experience, most entities credit all amounts received when the shares are originally issued to the common shares account, such that the entity does not report APIC (see section 5.3.20).

Interpretive response: An entity that does not report APIC due to having common shares with no par or stated value should follow guidance similar to that described in Question 5.8.90. That is, it follows state law guidance if such guidance exists. Otherwise, the entity makes an accounting policy election to apply one of three methods. However, in applying those methods, an entity compares the repurchase price of the treasury shares to the original ‘cost’ of those shares – i.e. the amount at which the shares were originally issued (see Question 5.8.110).

Method 1	Allocate the excess of the repurchase price over the cost of the shares between common shares and retained earnings, subject to the limitations described in Method 1 in Question 5.8.90.
Method 2	Charge the excess of the repurchase price over the cost of the shares to retained earnings.
Method 3	Charge the excess of the repurchase price over the cost of the shares to common shares, subject to the limitations described in Question 5.8.90.

5.8.50 Reissuance (resale) of treasury shares



Excerpt from ASC 505-30

> Subsequent Resale of Shares Repurchased

25-7 After an entity's repurchase of its own outstanding common stock, sometimes it may either retire the repurchased shares and issue additional common shares, or, as an alternative, resell the repurchased shares. In either case, the price received may differ from the amount paid to repurchase the shares. While the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such repurchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. There is no essential difference between the following:

- a. The repurchase and retirement of a corporation's own common stock and the subsequent issue of common shares
- b. The repurchase and resale of its own common stock.

25-8 Even though there may be cases where the transactions involved are so inconsequential as to be immaterial, as a broad general principle, such transactions shall not be reflected in retained earnings (either directly or through inclusion in the income statement). The qualification shall not be applied to any transaction that, although in itself inconsiderable in amount, is a part of a series of transactions that in the aggregate are of substantial importance.

25-9 The difference between the repurchase and resale prices of a corporation's own common stock shall be reflected as part of the capital of a corporation and allocated to the different components within stockholder equity as required by paragraphs 505-30-30-5 through 30-10.

> Allocating the Cost of Treasury Shares to Components of Shareholder Equity Upon Formal or Constructive Retirement

30-10 Gains on sales of treasury stock not previously accounted for as constructively retired shall be credited to additional paid-in capital; losses may be charged to additional paid-in capital to the extent that previous net gains from sales or retirements of the same class of stock are included therein, otherwise to retained earnings.

When an entity reissues (sells) treasury shares, it recognizes a gain or loss as an equity transaction (instead of in earnings). Whether a gain or a loss results from the sale depends on whether proceeds received upon reissuance are greater than or less than, respectively, the repurchase price (cost) of those treasury shares. [505-30-25-7]



Question 5.8.110

How is the cost of individual shares in treasury share transactions determined?

Interpretive response: We believe the cost of individual shares may be determined using an appropriate method – e.g. specific identification, weighted-average cost or FIFO.

The selection of a method represents an accounting policy, which is required to be applied consistently. Further, the entity should consider disclosing the policy in its financial statements.



Question 5.8.120

How are gains and losses from the reissuance (resale) of treasury shares reported?

Interpretive response: It depends on whether a gain or a loss results from the sale. [505-30-30-10]

- Gains are credited to APIC.
- Losses may be charged to APIC to the extent that previous net gains from sales or retirements of the same class of shares are included in APIC; otherwise they are charged to retained earnings.

An entity may not separately report APIC – e.g. because its common shares have no par or stated amount and it credits all amounts received when the shares are originally issued to the common shares account (see section 5.3.20). In that case, it records a gain as an increase in the common shares account.



Example 5.8.10

Treasury shares subsequently partially resold and partially retired

On January 1, Year 1, Issuer issues 1,000 common shares with a par value of \$1 for \$10 per share.

Issuer records the sale of the shares through the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	10,000	
Common shares – par value ¹		1,000
APIC ²		9,000
<i>To recognize issuance of common shares.</i>		
Notes:		
1. \$1 par value per share × 1,000 shares issued.		
2. Excess of proceeds from issuance of shares (\$10,000) – Par value of shares issued (\$1,000). Alternatively, per-share excess of proceeds (\$9 = \$10 proceeds – \$1 par) × 1,000 shares issued.		

On July 1, Year 1, Issuer repurchases 200 of its common shares for \$13 per share. The shares are held as treasury shares (i.e. the shares are not retired). Issuer records the transaction through the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Treasury shares	2,600	
Cash		2,600
<i>To recognize repurchase of common shares, which are not retired.</i>		

On October 1, Year 1, Issuer sells 50 of the treasury shares for \$15 per share and records the sale through the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	750	
Treasury shares ¹		650
APIC ²		100
<i>To recognize sale of treasury shares.</i>		
Notes:		
1. Cost of treasury shares (\$13 per share) × 50 shares reissued / sold.		
2. [Reissuance / sale price (\$15 per share) – Repurchase price (\$13 per share)] × 50 shares reissued / sold. Gains on reissuances / sales of treasury shares are credited to APIC (see Question 5.8.120).		

On December 1, Year 1, Issuer retires 50 treasury shares. Issuer elects to allocate the excess of the repurchase price over the par value between APIC and retained earnings, with limitations on the amount allocated to APIC (Method one in Question 5.8.90). The limitations are as follows.

Treasury shares repurchase price ¹	\$ 650	
Par value ²	(50)	
Amount to be allocated between APIC and retained earnings		\$ 600

APIC limitation:		
APIC arising from previous retirements and net gains on sales of treasury shares of the same issue ³ ; plus	100	
The pro rata portion of APIC on the same issue ⁴	450	
Amount to be allocated to APIC		550
Remaining amount to be allocated to retained earnings		\$ 50

Notes:

1. Repurchase price per share (\$13) × 50 shares.
2. Par value per share (\$1) × 50 shares.
3. Prior gains on sales of treasury shares on October 1, Year 1.
4. Excess of proceeds over par per share (\$9) from original issuance of shares on January 1, Year 1 × 50 shares.

Based on these calculations, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Common shares	50	
APIC	550	
Retained earnings	50	
Treasury shares		650
<i>To recognize retirement of treasury shares.</i>		

**Example 5.8.20****Issuance and resale of treasury shares**

The transactions and journal entries in this example are the same as those in Example 5.8.10 from January 1, Year 1, through October 1, Year 1. However, in this example, Issuer has different transactions in December, Year 1.

On December 1, Year 1, Issuer sells 100 treasury shares for \$12 per share, which is less than the \$13 cost (repurchase price) of those shares on January 1, Year 1. As discussed in Question 5.8.120, losses on sales of treasury shares may be charged to APIC to the extent that previous net gains from sales or retirements of the same class of shares are included APIC; otherwise they are charged to retained earnings.

The limitation to allocating the loss from the December 1, Year 1 sale to APIC is \$100 – i.e. the ‘gain’ from the sale of treasury shares that occurred on October 1, Year 1.

Issuer records the sale on December 1, Year 1 through the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	1,200	
APIC ¹	100	
Treasury shares		1,300
<i>To recognize sale of treasury shares.</i>		
Note:		
1. Excess of cost per treasury share – Price per share for which Issuer sold the treasury shares (i.e. \$13 – \$12) × 100 shares sold. This is equal to the \$100 limitation for allocating losses on treasury shares to APIC. As a result of this sale, the remaining gain in APIC related to treasury share transactions is zero.		

On December 31, Year 1, Issuer sells the remaining 50 treasury shares for \$10 per share, which is less than the \$13 cost (repurchase price) of those shares on January 1, Year 1. After the December 1, Year 1 sale of treasury shares, Issuer had no amounts remaining in APIC related to treasury shares. As a result, it must allocate the 'loss' on sale of treasury shares on December 31, Year 1 to retained earnings. Issuer records the sale through the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	500	
Retained earnings ¹	150	
Treasury shares		650
<i>To recognize sale of treasury shares.</i>		
Note:		
1. Excess of cost per treasury shares – Price per share for which Issuer sold the treasury shares (i.e. \$13 – \$10) × 50 shares.		

5.8.60 Accelerated share repurchase programs



Excerpt from ASC 505-30

> Accelerated Share Repurchase Programs

25-5 An accelerated share repurchase 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.

25-6 An entity shall account for such an accelerated share repurchase program as the following two separate transactions:

- a. As shares of common stock acquired in a treasury stock transaction recorded on the acquisition date
- b. As a forward contract indexed to its own common stock. Subtopic 815-40 provides guidance on the accounting for contracts that are indexed to an entity's own common stock

Example 1 (see paragraph 505-30-55-1) provides an illustration of an accelerated share repurchase program that is addressed by this guidance.

An ASR program is a combination of transactions that allow an entity to repurchase a targeted number of shares immediately, with the final repurchase price determined by an average market price over a fixed period of time. The purpose is to combine the following benefits: [\[505-30-25-5\]](#)

- the immediate share retirement benefits of a tender offer; and
- the market effect and pricing benefits of a disciplined daily open market share repurchase program.

An entity generally accounts for an ASR as the following two separate transactions: [\[505-30-25-6\]](#)

- a repurchase of common shares in a treasury share transaction recorded on the acquisition date; and
- a net-settled forward sale contract.

See KPMG Handbook, [Earnings per share](#), Question 6.15.40, for further information on the EPS implication of ASR programs. [\[260-10-55-88 – 55-89\]](#)



Question 5.8.130

What does a typical ASR program include?

Interpretive response: A typical ASR program includes the following.

- To facilitate an ASR program, an investment bank might borrow shares and short-sell them to the issuer at the current market value. The shares are held in treasury; the issuer has legal title to the shares and no other party can vote the shares. At the same time, the issuer enters into a net-settled (see section 8.10.20) forward sale contract with the same investment bank for the same number of shares the entity just purchased.
- Over the course of a few weeks to several months – depending on the facts and circumstances of the arrangement and the issuer stock's daily trading volume – the investment bank purchases shares of the issuer's stock in the open market.
- The forward will settle based on the difference between the average share price over a period of time and the initial share repurchase price.

- If the forward is in a loss position to the entity – i.e. the average share price is greater than the initial share purchase price – the entity has the choice to settle the amount in net cash or net shares.
- If the forward is in a gain position – i.e. the average share price is less than the initial share purchase price – the entity will receive net cash.

Frequently, the entity is permitted to choose whether to net-settle the forward in cash or shares.



Question 5.8.140

Is an ASR program always accounted for as two separate transactions?

Interpretive response: Not necessarily. We believe an entity evaluates the ASR's contractual terms (which may be documented in separate contracts or in a single contract) to identify features not present in the transaction described in Topic 505. Some features in an ASR program may raise questions as to whether the treasury share repurchase is separable from the forward sale contract for accounting purposes.

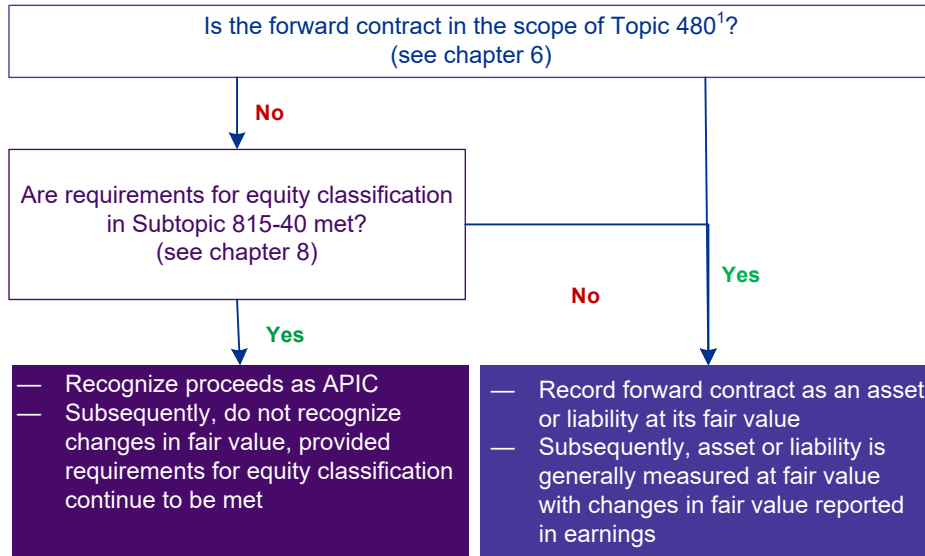
An example of a contractual feature that indicates it is not appropriate to account for the two elements as separate transactions is a provision that provides the entity with control of timing, quantity and pricing of market share purchases made by the investment bank to fulfill the forward contract. When the entity, instead of the investment bank, controls these purchases, the investment bank may be merely acting as an agent of the entity.



Question 5.8.150

When an ASR is accounted for as two transactions, how is the forward contract classified?

Interpretive response: An entity determines the appropriate balance sheet classification based on the steps summarized in the following decision tree.



Note:

1. For example, a forward contract relating to the issuance of redeemable instruments or preferred shares that are redeemable at the holder's option may be in the scope of Topic 480.



Question 5.8.160

How is the cost basis of the total number of shares purchased under an ASR agreement calculated?

Interpretive response: We believe the method for calculating the cost basis of the total number of shares purchased under the ASR is an accounting policy election (to be applied consistently). The two policy options are:

- actual cost of each share; or
- average cost of each share.



Excerpt from ASC 505-30

> Illustrations

- > Example 1: Accelerated Share Repurchase Program

55-1 This Example illustrates the guidance in paragraph 505-30-25-5 by identifying the two separate transactions, namely a treasury stock purchase and a forward contract, that are present in what is sometimes described as an accelerated share repurchase program.

55-2 The treasury stock purchase is as follows.

55-3 Investment Banker, an unrelated third party, borrows 1,000,000 shares of Company A common stock from investors, becomes the owner of record of

those shares, and sells the shares short to Company A on July 1, 1999, at the **fair value** of \$50 per share. Company A pays \$50,000,000 in cash to Investment Banker on July 1, 1999, to settle the purchase transaction. The shares are held in treasury. Company A has legal title to the shares, and no other party has the right to vote those shares.

55-4 The forward contract is as follows.

55-5 Company A simultaneously enters into a forward contract with Investment Banker on 1,000,000 shares of its own common stock. On the October 1, 1999, settlement date, if the volume-weighted average daily market price of Company A's common stock during the contract period (July 1, 1999, to October 1, 1999) exceeds the \$50 initial purchase price (net of a commission fee to Investment Banker), Company A will deliver to Investment Banker cash or shares of common stock (at Company A's option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A's common stock during the contract period is less than the \$50 initial purchase price (net of a commission fee to Investment Banker), Investment Banker will deliver to Company A cash equal to the price difference multiplied by 1,000,000.

55-6 Under the guidance in paragraph 505-30-25-5, an entity would account for this accelerated share repurchase program as two separate transactions:

- a. As shares of common stock acquired in a treasury stock transaction recorded on the July 1, 1999, acquisition date
- b. As a forward contract indexed to its own common stock.

55-7 See Example 13 (paragraph 260-10-55-88) for the effect on earnings per share (EPS) for this Example.



Example 5.8.30 ASR program

This Example is based on Subtopic 505-30's Example 1 (above). It further explains the accounting for the forward contract and related EPS impact of the FASB example.

Based on the facts in the FASB example, Company A records the purchase of the 1 million shares at a cost of \$50 million. Company A may classify the forward contract as equity if it is not a liability under Topic 480 (see chapter 6) and equity classification is appropriate under Subtopic 815-40 (see chapter 8). The forward contract's settlement provisions are consistent with equity classification under Subtopic 815-40, even though Company A will (see section 8.10.20):

- receive cash when the contract is in a gain position; but
- pay cash or shares at its option when the contract is in a loss position.

If classified in equity, Company A records no changes in the fair value of the forward contract and records settlement of the contract in equity. Company A immediately reduces outstanding shares used to calculate the weighted-

average common shares outstanding for EPS by the 1 million shares received at the purchase date.

5.9 Spinoffs and reverse spinoffs

5.9.10 Overview



Excerpt from ASC 505-60

05-2 An entity may desire to reorganize its operations in response to its business needs. For example, an entity (the spinnor) may transfer assets into a new legal spun-off entity (the spinnee) and distribute the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor. Such a transaction is commonly referred to as a spinoff. An illustration of a spinoff is presented in Example 1 (see paragraph 505-60-55-1).

05-3 A spinoff allows an entity to be reorganized in a manner that allows it to meet the needs of its owners. However, there may be other benefits as well. If the spinoff qualifies as a nontaxable reorganization, the distribution results in no taxable gain being recognized by either the spinnor or its shareholders. Additionally, if the spinnee is subsequently sold by the shareholders, the double taxation that would have occurred if an entity sold its subsidiary directly and distributed the proceeds to its shareholders is avoided.

05-4 In certain cases, the spinoff of a subsidiary to its shareholders is such that the legal form of the transaction does not match its substance. That is, in certain circumstances, the spinnee will be the continuing entity and the transaction will commonly be referred to as a **reverse spinoff**. An entity needs to determine whether to account for a spinoff as a reverse spinoff based on the substance instead of the legal form of the transaction. An illustration of a reverse spinoff is presented in Example 2 (see paragraph 505-60-55-4).

> Entities

15-1 The guidance in this Subtopic applies to all entities, unless more specific guidance is provided in other Topics.

> Transactions

15-2 The guidance in this Subtopic applies to all transactions involving the distribution of nonmonetary assets that constitute a business to owners of an entity.

15-3 The guidance in this Subtopic does not apply to distributions of nonmonetary assets that do not constitute a business.

20 Glossary

Reverse Spinoff

A spinoff of a subsidiary to an entity's shareholders in which the legal form of the transaction does not match its substance such that the new legal spun-off entity (the spinnee) will be the continuing entity.

Spinoff

The transfer of assets that constitute a business by an entity (the spinor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinor.

A spinoff is essentially a reorganization in which an entity (the spinor) incorporates a new entity (the spinnee) and transfers a business to it. The spinor then distributes the spinnee's shares to its own shareholders for no consideration. A spinoff is a common tactic for divesting assets in a tax-advantaged manner and is accounted for at book value (see section 5.9.20). [505-60-05-2]

**Question 5.9.10**

Is a nonreciprocal transfer of a subsidiary's shares by a parent to its shareholders a spinoff or a PIK dividend?

Interpretive response: If the subsidiary's shares transferred to the spinnee constitutes a business (as defined in Topic 805), the transaction is, in substance, generally a spinoff and is accounted for under Subtopic 505-60 (see section 5.9.20). Otherwise the transaction represents a PIK dividend and is accounted for under Topic 845 (see section 5.6.30). A spinoff is recorded based on the historical carrying amount of the transferred net assets (less any impairment losses; see Question 5.9.40). In contrast, a PIK dividend is generally recorded at the fair value of the transferred assets (see Question 5.6.70).

Determining whether a set of assets and activities represents a business is a matter of judgment that requires an evaluation of all relevant facts and circumstances. See section 2 of KPMG Handbook, [Business combinations](#).

5.9.20 Accounting for spinoffs and reverse spinoffs

**Excerpt from ASC 505-60**

> Required Accounting for Spinoffs, Including Reverse Spinoffs

25-2 Paragraph 845-10-30-10 requires that the accounting for the distribution of nonmonetary assets to owners of an entity in a spinoff be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value). As specified in Section 505-60-15, a further requirement of the nonmonetary assets being distributed is that they constitute a **business**. Accordingly, an entity's distribution of the shares of a wholly owned or consolidated subsidiary to its shareholders shall be recorded based on the carrying value of the subsidiary. Regardless of whether the spun-off operations will be sold immediately after the spinoff, the transaction shall not be

accounted for as a sale of the accounting spinnee followed by a distribution of the proceeds.

25-3 See Example 1 (paragraph 505-60-55-1) for an illustration of a spinoff transaction.

25-4 In a reverse spinoff, the legal spinnee shall be treated as though it were the spinnor for accounting purposes (accounting spinnor). This is referred to as reverse spinoff accounting.

25-5 Accounting for a reverse spinoff transaction based on its legal form would present the legal spinnor as the accounting spinnor and the legal spinnee as the accounting spinnee. However, in substance, the legal spinnor has disposed of its own operations and continued the operations of the legal spinnee. The legal form of the spinoff may have been driven primarily by tax planning strategies. Accounting for the transaction based on its substance depicts the legal spinnee as the accounting spinnor and the legal spinnor as the accounting spinnee.

25-6 See Example 2 (paragraph 505-60-55-4) for an illustration of a reverse spinoff transaction.

25-7 Reverse spinoff accounting is appropriate if treatment of the legal spinnee as the accounting spinnor results in the most accurate depiction of the substance of the transaction for shareholders and other users of the financial statements. The determination of whether reverse spinoff accounting is appropriate is a matter of judgment that depends on an evaluation of all relevant facts and circumstances. The following paragraph provides guidance on making the required determination.

> Determining the Accounting Spinnor and Spinnee

25-8 In order to determine the required accounting and reporting in a spinoff transaction, an entity needs to determine which party is the accounting spinnor and which is the accounting spinnee. In determining whether reverse spinoff accounting is appropriate, a presumption shall exist that a spinoff be accounted for based on its legal form, in other words, that the legal spinnor is also the accounting spinnor. However, that presumption may be overcome. An evaluation of the following indicators shall be considered in that regard. Nevertheless, no one indicator shall be considered presumptive or determinative. The following are indicators that a spinoff should be accounted for as a reverse spinoff:

- a. The size of the legal spinnor and the legal spinnee. All other factors being equal, in a reverse spinoff, the accounting spinnor (legal spinnee) is larger than the accounting spinnee (legal spinnor). The determination of which entity is larger is based on a comparison of the assets, revenues, and earnings of the two entities. There are no established bright lines that shall be used to determine which entity is the larger of the two.
- b. The fair value of the legal spinnor and the legal spinnee. All other factors being equal, in a reverse spinoff, the fair value of the accounting spinnor (legal spinnee) is greater than that of the accounting spinnee (legal spinnor).
- c. Senior management. All other factors being equal, in a reverse spinoff, the accounting spinnor (legal spinnee) retains the senior management of the formerly combined entity. Senior management generally consists of the

chairman of the board, chief executive officer, chief operating officer, chief financial officer, and those divisional heads reporting directly to them, or the executive committee if one exists.

- d. Length of time to be held. All other factors being equal, in a reverse spinoff, the accounting spinnor (legal spinnee) is held for a longer period than the accounting spinnee (legal spinnor). A proposed or approved plan of sale for one of the separate entities concurrent with the spinoff may identify that entity as the accounting spinnee.

See Examples 3 and 4 (paragraphs 505-60-55-7 through 55-12) for illustrations of the determination of the accounting spinnor and spinnee.

45-1 The determination of the accounting spinnor and spinnee under the requirements of paragraph 505-60-25-8 may have significant implications with regard to the reporting of discontinued operations in accordance with Subtopic 205-20. That is, the accounting spinnee shall be reported as a discontinued operation by the accounting spinnor if the spinnee is a discontinued operation and meets the conditions for such reporting contained in paragraphs 205-20-45-1A through 45-1C.

The first step in accounting for a spinoff is to determine whether the transaction is a spinoff or a reverse spinoff. A spinoff transaction is presumed to follow its legal form, although that presumption may be overcome based on consideration of certain factors. [505-60-25-4]

Spinoff	The spinnor is divesting itself of one or more businesses, but still continues operating other businesses. In a spinoff, the legal spinnor is treated as the accounting spinnor.
Reverse spinoff	The legal spinnee is essentially continuing the legal spinnor's operations. In such a transaction, the legal spinnor is treated as the accounting spinnee and therefore is called the 'legal spinnor, accounting spinnee'.

Guidance in other topics also addresses the accounting for certain spinoffs:

- Paragraph 360-10-40-4 addresses accounting for long-lived assets to be exchanged or distributed to owners in a spinoff.
- Paragraph 715-30-60-8 describes the accounting for pension plan spin-offs.



Question 5.9.20

How does an entity distinguish between a spinoff and a reverse spinoff?

Interpretive response: In a spinoff, the legal spinnor is essentially transferring one or more businesses to the legal spinnee and divesting of those operations by distributing the legal spinnee's shares to the spinnor's shareholders. Such a transaction is presumed to be a spinoff instead of a reverse spinoff. In overcoming this presumption, an entity considers which model (spinoff or reverse spinoff) results in the most accurate depiction of the transaction's substance. [505-60-25-8]

There are four specified indicators of a reverse spinoff to be considered when evaluating whether the presumption of a spinoff has been overcome. If one of these indicators exists and none of the others suggest an opposite result, a transaction is considered a reverse spinoff. However, if there are indicators that suggest an opposite result, significant judgment is required when determining whether the presumption of a spinoff has been overcome. [505-60-25-8]

Indicator	Relevance
Size of legal spinnor and legal spinnee	A reverse spinoff is indicated if the legal spinnee (accounting spinnor) is larger than the legal spinnor (accounting spinnee). Size is measured based on assets, revenues and earnings, but there are no bright lines for determining when this indicator exists. [505-60-25-8(a)]
Fair value of legal spinnor and legal spinnee	A reverse spinoff is indicated if the fair value of the legal spinnee (accounting spinnor) is greater than that of the legal spinnor (accounting spinnee). [505-60-25-8(b)]
Senior management	A reverse spinoff is indicated when the legal spinnee (accounting spinnor) retains the legal spinnor's (accounting spinnee's) senior management – i.e. chairman of the board, CEO, COO, CFO, divisional heads reporting to these officials, or the executive committee if one exists. [505-60-25-8(c)]
Length of time to be held	A reverse spinoff is indicated when the legal spinnee (accounting spinnor) is held for a longer period than the legal spinnor (accounting spinnee). For example, a proposed or approved plan to sell one of the entities concurrent with the spinoff indicates that the entity to be sold is the accounting spinnee. [505-60-25-8(d)]



Example 5.9.10

Determining whether a transaction is a spinoff or reverse spinoff

ABC Corp. (the legal spinnor) creates DEF Corp. (the legal spinnee) and transfers the majority of its operations (75% of the fair value of its net assets) to DEF.

ABC:

- distributes DEF's shares pro rata to its shareholders;
- previously owned and operated retail stores; and
- will continue to own the real estate but will no longer own retail operations.

DEF will operate the stores after the spinoff.

One indicator that the legal spinnee is the accounting spinnor (i.e. the divesting entity) is that the fair value of the legal spinnee is greater than that of the legal spinnor (see Question 5.9.20). In this example, ABC transfers 75% of the fair value of its net assets to DEF. Further, none of the other indicators suggest an opposite result.

Therefore, although ABC is the legal spinor for accounting purposes, DEF (the legal spinnee) is the divesting entity and is therefore the accounting spinor.



Question 5.9.30

Is an entity required to use a fair value measured under Topic 820 when distinguishing between a spinoff and a reverse spinoff?

Interpretive response: Not necessarily. In some situations, we believe the fair value analysis may use the fair market value for tax purposes, calculated to determine a shareholder's tax basis in the shares of the spun-off entity.



Question 5.9.40

How are a spinoff and a reverse spinoff accounted for and presented in financial statements?

Interpretive response: The accounting and presentation are summarized below. In addition, chapter 6 of KPMG Handbook, [Discontinued operations & HFS disposal groups](#), discusses the presentation of discontinued operations.

Accounting

An accounting spinor does not account for a spinoff as a sale of the accounting spinnee followed by a distribution of the proceeds, even if the spun-off operations will be sold immediately after the spinoff. [\[505-60-25-2\]](#)

Instead, the accounting spinor records the historical carrying amount (less any impairment losses) of the net assets transferred to the accounting spinnee as a dividend. The amount is charged to either retained earnings or APIC, depending on whether retained earnings is a deficit.

- Retained earnings is not a deficit: Amount is charged directly to retained earnings.
- Retained earnings is a deficit: Amount may be charged to either APIC (provided state law does not prohibit that treatment) or the accumulated deficit.

Presentation

- The **accounting spinor** presents the combined operations of both entities through the spinoff date.
 - The **accounting spinnee** presents as its historical financial statements the carved out financial statements for only the transferred operations.
-



Excerpt from ASC 505-60

> Illustrations

• > Example 1: Spinoff

55-1 This Example presents an illustration of a **spinoff**.

55-2 Big Company owns and operates a mall and a retail store that occupies the anchor store position in that mall. The mall and the store are managed by two separate divisions. The shareholders of Big Company would like to split Big Company into two entities so that each can focus on its own operations. To achieve this, Big Company transfers the mall's assets and operations into a newly created subsidiary, Mall Company, and distributes the shares of Mall Company to its shareholders on a pro rata basis in a spinoff.

55-3 Paragraph 505-60-25-2 provides guidance on the accounting for a spinoff.

• > Example 2: Reverse Spinoff

55-4 This Example presents an illustration of a reverse **spinoff**.

55-5 Snack Food Company owns two subsidiaries—Ice Cream Subsidiary and Snack Subsidiary. Ice Cream Subsidiary is significantly larger and more profitable than Snack Subsidiary. The shareholders of Snack Food Company would like to continue the ice cream operations and dispose of the snack food operations. To facilitate this, Snack Food Company distributes the shares of Ice Cream Subsidiary to the shareholders thereby creating Ice Cream Company. The shareholders are then able to dispose of the operations of Snack Food Company (now solely comprising Snack Subsidiary operations) by selling the shares directly to a third party and, at the same time, retain ownership of the Ice Cream Company.

55-6 Paragraphs 505-60-25-4 through 25-7 provide guidance on the accounting for a reverse spinoff.

• > Example 3: Legal Form of Spinoff Same As Transaction Substance

55-7 This Example demonstrates the application of the requirements in paragraph 505-60-25-8 to identify the accounting spinner and spinnee, which may differ from the legal spinner and spinnee. This Example has the following assumptions:

- a. Retail Company, a retail store chain, has a wholly owned restaurant subsidiary. The retail and restaurant operations are operated independently with a small executive management team overseeing both. Because the two have unrelated operations, the shareholders believe that the two operations should be separated by way of a spinoff. They believe that this will allow those separate entities to pursue opportunities in their respective industries and maximize their individual value.
- b. In order to accomplish the spinoff, Retail Company creates a new legal entity, Restaurant Company, into which the assets and operations of the restaurant subsidiary are transferred. The shares of Restaurant Company are then distributed to the shareholders of Retail Company on a pro rata basis.

- c. The executive management team of Retail Company will be divided between the two entities. A comparison of the two entities is as follows.

	(in 000s)			
	Assets	Revenues	Net Income	Fair Value
Retail	\$ 500	\$ 410	\$ 150	\$ 675
Restaurant	\$ 100	\$ 75	\$ 21	\$ 170

55-8 Based on an analysis of the indicators contained in paragraph 505-60-25-8, the spinoff should be accounted for in accordance with its legal form. That is, the transaction should not be accounted for as a reverse spinoff. Retail Company should be designated as the accounting spinor based on the first two of the following indicators:

- a. Retail Company has substantially larger operations than Restaurant Company.
- b. The fair value of Retail Company is greater than Restaurant Company.
- c. The management team is allocated between the two operations.
- d. There are no planned or likely disposals of either Retail Company or Restaurant Company.

55-9 The designation of Retail Company as the accounting spinor will provide the most accurate depiction of the transaction to shareholders and other users of the financial statements because, in substance, Retail Company has spun off its Restaurant Company into a separate entity.

- > Example 4: Legal Form of Spinoff Differs from Transaction Substance

55-10 This Example demonstrates the application of the requirements in paragraph 505-60-25-8 to identify the accounting spinor and spinnee, which may differ from the legal spinor and spinnee. This Example has the following assumptions:

- a. Retail Company, a retail store chain, has a wholly owned restaurant subsidiary. The retail and restaurant operations are operated independently, with a small executive management team overseeing both. While the restaurant subsidiary has grown rapidly, the retail operations have deteriorated steadily due to increased competition. The shareholders believe that the two operations should be separated by way of a spinoff. Management intends to dispose of the retail operations.
- b. In order to accomplish the spinoff, Retail Company creates a new legal entity, Restaurant Company, into which the assets and operations of the restaurant subsidiary are transferred. The shares of Restaurant Company are then distributed to the shareholders of Retail Company on a pro rata basis.
- c. The executive management team of the combined entity will be assigned primarily to Restaurant Company, as the intent is to dispose of Retail Company (now solely comprising the retail operations). A comparison of certain statistics of the two entities is as follows.

	(in 000s)			
	Assets	Revenues	Net Income	Fair Value
Retail	\$ 300	\$ 210	\$ 35	\$ 375
Restaurant	\$ 600	\$ 450	\$ 150	\$ 700

55-11 Based on an analysis of the indicators contained in paragraph 505-60-25-8, the spinoff should be accounted for as a reverse spinoff. Restaurant Company, although the legal spinnee, should be designated as the accounting spinnor based on the following:

- a. Restaurant Company has substantially larger operations than Retail Company.
- b. The fair value of Restaurant Company is greater than that of Retail Company.
- c. The management team is primarily assigned to Restaurant Company.
- d. Management intends to dispose of Retail Company upon finalizing the spinoff.

55-12 The designation of Restaurant Company as the accounting spinnor will provide the most accurate depiction of the transaction to shareholders and other users of the financial statements, as, in substance, Retail Company has disposed of its retail operations and continued its restaurant operations.



Question 5.9.50

Can an entity omit a subsidiary from its historical financial statements if the subsidiary has been spun off?



Excerpt from SAB Topic 5.Z.7

Accounting for the Spin-off of a Subsidiary

Facts: A Company disposes of a business through the distribution of a subsidiary's stock to the Company's shareholders on a pro rata basis in a transaction that is referred to as a spin-off.

Question: May the Company elect to characterize the spin-off transaction as resulting in a change in the reporting entity and restate its historical financial statements as if the Company never had an investment in the subsidiary, in the manner specified by FASB ASC Topic 250, Accounting Changes and Error Corrections?

Interpretive Response: Not ordinarily. If the Company was required to file periodic reports under the Exchange Act within one year prior to the spin-off, the staff believes the Company should reflect the disposition in conformity with FASB ASC Topic 360. This presentation most fairly and completely depicts for investors the effects of the previous and current organization of the Company. However, in limited circumstances involving the initial registration of a company under the Exchange Act or Securities Act, the staff has not objected to financial statements that retroactively reflect the reorganization of the business as a change in the reporting entity if the spin-off transaction occurs prior to effectiveness of the registration statement. This presentation may be acceptable in an initial registration if the Company and the subsidiary are in dissimilar businesses, have been managed and financed historically as if

they were autonomous, have no more than incidental common facilities and costs, will be operated and financed autonomously after the spin-off, and will not have material financial commitments, guarantees, or contingent liabilities to each other after the spin-off. This exception to the prohibition against retroactive omission of the subsidiary is intended for companies that have not distributed widely financial statements that include the spun-off subsidiary. Also, dissimilarity contemplates substantially greater differences in the nature of the businesses than those that would ordinarily distinguish reportable segments as defined by FASB ASC paragraph 280-10-50-10 (Segment Reporting Topic).

Interpretive response: A spinoff transaction generally does not represent a change in reporting entity that would permit omission of the subsidiary from the reporting entity's historical financial statements prior to the spinoff. However, SAB Topic 5.Z.7 (excerpted above) describes certain limited situations in which the SEC staff would not object to such presentation. We believe all factors described in SAB Topic 5.Z.7 must be met for an entity to conclude that a change in reporting entity has occurred. [SAB Topic 5.Z.7]

See KPMG Handbook, [Business combinations](#), for further guidance (beginning at paragraphs 28.030).

5.10 Costs relating to share issuance

5.10.10 Overview

The accounting treatment of the costs to issue shares may differ depending on the types of costs incurred.

Types of costs	Addressed in
Related to the issuance of equity shares	section 5.10.20
Associated with a failed share offering	section 5.10.30
Re-audit of prior-year financial statements	section 5.10.40
Incurred in an offering in which the entity will receive no proceeds	section 5.10.50
Cost of registering shares in a business combination	section 5.10.60
Share issuance costs paid by a shareholder	section 5.10.70

5.10.20 Costs incurred to issue equity shares



Excerpt from SAB Topic 5.A

Expenses of Offering

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

Question: Should such costs be deferred?

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

An entity charges specific incremental costs directly attributable to a shares offering against the proceeds of that offering. Such costs may include the following direct and incremental costs – fees charged by:

- underwriters;
- attorneys;
- accountants; and
- printers.

Because these costs reduce the proceeds from the share issuance, they also reduce the amount recorded in equity. [SAB Topic 5.A]

Direct and incremental fees are deferred if they are incurred in connection with an SEC filing for shares an entity plans to sell under a shelf registration. These deferred fees are recognized when the securities are sold by charging them against APIC. [SAB Topic 5.A]



Question 5.10.10

How are costs incurred leading up to the issuance of equity shares reported?

Interpretive response: An entity may defer costs incurred before its issuance of shares if those costs are both direct and incremental. If an entity incurs direct, incremental costs in the time leading up to a share offering, these costs may be recorded as an asset until the offering is complete, at which time the costs reduce the proceeds. If the share offering is later aborted or withdrawn, the entity expenses these costs at that time. [SAB Topic 5.A]

**Example 5.10.10****Direct and incremental costs in connection with the issuance of common shares**

Issuer incurs legal fees of \$545,000 over the course of several weeks leading up to a share offering during Year 1. On March 15, Year 2, the offering is complete and Issuer issues 1 million common shares with a par value of \$1 per share for \$10 per share.

Based on these facts, the costs may be deferred until the offering is complete, at which time the costs will reduce the proceeds.

Issuer records the following journal entry during Year 1 to defer the legal cost incurred relating to the offering.

	<i>Debit</i>	<i>Credit</i>
Deferred direct and incremental legal costs	545,000	
Cash		545,000
<i>To recognize costs incurred during period leading up to issuance of common shares.</i>		

Issuer records the following journal entry upon the completion of the offering in Year 2.

	<i>Debit</i>	<i>Credit</i>
Cash	10,000,000	
Deferred direct, incremental costs		545,000
Common shares		1,000,000
APIC ¹		8,455,000
<i>To recognize proceeds from issuance of common shares.</i>		
Note:		
1. Proceeds received (\$10 million) – Par value of common shares issued (\$1 million) – Direct and incremental legal costs incurred (\$545,000).		

**Question 5.10.20****Are internal costs associated with the issuance of common shares expensed?**

Interpretive response: Yes. An entity records all internal costs, such as salaries and other general and administrative expenses, as current period expenses because these costs would have been incurred even without the share offering.

[SAB Topic 5.A]

**Example 5.10.20****Internal costs incurred in connection with the issuance of common shares**

On February 15, Year 2, Issuer issues 10 million common shares with a par value of \$1 per share for \$12 per share.

Issuer incurs the following costs in connection with the process of issuing its common shares.

Underwriting fees	\$ 1,000,000
External legal fees	250,000
Financial statement audit	350,000
Executive travel costs	50,000

Issuer also determines that its personnel in the accounting and legal department spent approximately 1,000 hours working directly on the share offering. The estimated value of the salaries and fringe benefits associated with these hours is \$150,000.

The financial statement audit fee represents the fiscal Year 1 audit. The Year 1 financial statements were included in the prospectus prepared for the share offering. The travel costs consist of out-of-pocket expenses incurred by top management as they met with potential investors.

Accounting

The underwriting fees, external legal fees, and executive travel costs, which total \$1.3 million, reduce the proceeds from the issuance of the shares because these represent direct and incremental costs of issuing the shares.

Issuer records the financial statement audit fees as a current period expense because these costs would have been incurred regardless of whether the share offering took place. Likewise, Issuer records all internal personnel costs of \$150,000 (e.g. salaries and benefits of employees working on the share offering) as a current-period expense because these costs also would have been incurred regardless of whether the share offering took place. These costs are recorded as period expenses in accordance with Issuer's normal process of accounting for these costs.

Issuer records the following journal entry related to the common shares issuance.

	<i>Debit</i>	<i>Credit</i>
Cash	120,000,000	
Common shares – par value		10,000,000
APIC		110,000,000
<i>To recognize proceeds received in connection with issuance of common shares.</i>		

For the common shares issuance costs incurred, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
APIC ¹	1,300,000	
Cash		1,300,000
<i>To recognize costs incurred leading up to issuance of common shares.</i>		
Note:		
1. Underwriting fees (\$1 million), external legal fees (\$250,000) and executive travel costs (\$50,000).		



Question 5.10.30

How are costs incurred to issue freestanding equity-classified instruments other than shares reported?

Background: An entity may incur costs associated with issuing freestanding equity-classified instruments other than shares. For example, an entity may incur costs in connection with issuing warrants that are classified as equity because they are not liabilities under Topic 480 (see chapter 6) and meet the conditions for equity classification in Subtopic 815-40 (see chapter 8).

Interpretive response: Costs that are both direct and incremental reduce the amount recorded in equity (APIC). This includes when those costs are paid to the counterparty of the instrument. [SAB Topic 5.A]

5.10.30 Costs incurred for failed share offering



Question 5.10.40

Can costs associated with a failed share offering be charged to a later share offering?

Interpretive response: No. The costs related to a failed share offering cannot be deferred and charged against a later share offering. A short postponement period (up to 90 days) does not represent an aborted offering. [SAB Topic 5.A]

Similarly, if at any point in time the entity determines that it will not issue additional shares under a shelf registration, it records any remaining deferred costs as an expense. Any costs incurred subsequent to the initial shelf registration to keep the filing alive are charged to expense as incurred. If the filing is withdrawn, the related deferred costs are charged to expense. [TPA 4110.07]

5.10.35 Accounting for sales commissions and certain distribution fees that are paid over time**

Sales commissions and distribution fees paid to a dealer-manager of publicly registered, non-listed direct participation programs have historically been paid to the dealer-manager at the time that the shares or units are sold. Such programs have included non-listed Real Estate Investment Trusts – i.e. non-traded REITS.

However, certain direct participation programs have evolved to include multiple classes of shares/units with different commission and fee arrangements, including a sales commission and distribution fee structure that pays the dealer-manager over a period not to exceed the time period the shares/units remain outstanding. These ongoing periodic fees to a dealer-manager are commonly referred to as trailing fees, and the class of security as T-shares.

While the terms under which trailing fees are paid to the dealer-manager vary, the dealer-manager may typically earn trailing fees if: [ISAB Topic 5.A, 340-10-S99-1](#)

- T-shares remain outstanding;
- the non-traded REIT does not list its shares on a national securities exchange;
- the non-traded REIT does not merge or consolidate with or into another entity or sell or otherwise dispose of all or substantially all of its assets;
- the total underwriting compensation for the offering does not exceed 10% of the gross proceeds raised from the primary portion of the offering; and
- related to stockholder servicing fees, ongoing services are provided.



Question 5.10.45**

How are the costs related to the sales of shares or units accounted for when they are paid over an extended period?

Interpretive response: Trailing fees are accrued as a liability and a reduction to equity when the T-share is sold unless a portion of the trailing fee:

- is attributed to a specifically identifiable service that is unrelated to sales commissions and distribution services;
- is incremental, can be reasonably measured and directly attributed to the separate service; and
- can be systematically and rationally allocated between the sales commissions and distribution fees and the separate service.



Question 5.10.46**

How are the costs related to the sales of shares or units initially and subsequently measured when they are paid over an extended period?

Interpretive response: The accrued liability, representing the trailing fee payments expected to be paid over time, may (but is not required to) be

measured on a discounted basis if the amount and timing of the future payments are fixed or reliably determinable. However, if the timing and amount of the future payments are not fixed or reliably determinable, the liability is recorded on an undiscounted basis. If the liability is estimated using discounted cash flows, the accretion of the discount is recorded in the income statement as a financing charge. Limitations on amounts paid based on regulatory thresholds required by FINRA (10% of trailing fees or 15% of trailing fees and offering costs) as a percentage of total proceeds are considered in the measurement of the obligation.

While the term 'fixed or reliably determinable' is not defined in the literature, we believe that all of the variables that might affect the amount or timing of the payments should be considered, including the terms of the shares/units, plans to pursue and probability of a liquidity event, terms of share repurchase programs, and entity-specific history. Considering the many variables, we believe whether future payments are reliably determinable requires careful evaluation. Although the liability is not a loss contingency, we believe that the guidance in Topic 450 should be considered, which would limit the discount rate to the risk-free rate for a monetary asset with a similar maturity. [SAB Topic 5.Y]

Subsequent measurement

Changes to the measurement of the liability (e.g. changes to the estimated future payments) are considered a change in estimate.

- If the liability was measured on an **undiscounted basis**, any change in estimate of the liability is offset against equity.
 - If the liability was measured on a **discounted basis**, any change in the estimate is bifurcated between an income statement finance charge and an offset against equity. The amount of the finance charge is calculated as the difference in accretion expense that would have been recognized if the change in amount or timing of payments had been known at the original recognition of the liability and the amount of accretion expense that had previously been recognized.
-

5.10.40 Re-audit prior year financial statements

An entity may incur costs to re-audit prior-year financial statements in connection with a shares offering – e.g. a predecessor auditor may not consent to inclusion of its report in the registration statement. Even if the requirement to re-audit prior-year financial statements results directly from the registration process, an entity records the related costs as a current period expense because they are not direct, incremental costs of issuing the shares. Therefore, they are not capitalized as a deferred charge, which would offset the proceeds from the share issuance.

5.10.50 Costs incurred in an offering in which the entity will receive no proceeds

Offering proceeds may be in the form of cash or may take forms other than cash. For example, an entity may issue shares in exchange for the net assets of another entity as part of a business combination. However, in some situations, an entity will not receive proceeds.

An entity expenses costs incurred in connection with an offering (e.g. registration costs) if it will not receive proceeds from the offering or if proceeds are not reasonably expected to exceed the costs. However, if the proceeds exceed the costs, then the costs are accounted for as an offset against equity. [SAB Topic 5.A]



Question 5.10.50

How are costs incurred in an offering both to register shares held by an investor and to raise proceeds accounted for?

Interpretive response: We believe that an entity should make an accounting policy election (applied consistently) for costs incurred to simultaneously register shares held by an investor and raise proceeds by issuing new shares.

We believe the following are acceptable accounting policies for allocating those costs.

- Allocate all of the direct registration and offering costs (both fixed and variable) on a proportional basis to all of the shares being registered – i.e. both the new shares and the selling shareholder shares. This gives each share registered the same cost per share.
- Allocate the direct fixed registration and offering costs (e.g. accounting costs, legal costs, printer costs) to the new shares, regardless of the number or nature of shares being registered. An entity could allocate all variable costs (e.g. underwriting fees and commissions, stock exchange registration fee) on a proportional basis to all of the shares.
- Allocate all of the direct registration and offering costs (both fixed and variable) to the new shares.

The costs allocated to register shares held by investors are recorded as an expense. The costs allocated to the new shares are accounted for as follows.

- Costs are less than proceeds received: netted against the proceeds in equity.
- Costs are greater than proceeds received: the excess of costs over proceeds received is recorded as an expense.

5.10.60 Costs of issuing shares in a business combination

When an entity issues equity shares to effect a business combination, it offsets the direct and incremental costs of the share issuance, if any, against the fair value of the shares as a reduction of equity. For example, if Issuer issues shares with a fair value of \$20 million and incurs \$1.5 million of direct and incremental share issuance costs, it records the net amount of \$18.5 million as an increase in equity.

See chapter 11 of KPMG Handbook, [Business combinations](#), for guidance on accounting for acquisition-related costs in a business combination (beginning at paragraph 11.061).

5.10.70 Share issuance costs paid by a shareholder

In certain circumstances, a shareholder may pay the cost of issuing shares. For example, a parent may pay the costs incurred to sell the shares of a subsidiary. Even though the costs were paid by a shareholder, they are reported in the issuer's financial statements as a reduction of proceeds of the share issuance.

The offsetting journal entry depends on whether the issuer will reimburse the shareholder, either directly or indirectly:

- If the issuer will reimburse the shareholder, it records a liability.
- If the issuer will not reimburse the shareholder, it increases equity to record the contribution to it from the shareholder.

5.12 Presentation and disclosure

5.12.10 Overview

Both US GAAP and SEC rules and regulations contain requirements for presenting and disclosing equity and equity transactions. This section addresses those requirements as they relate to the equity instruments and transactions discussed in chapter 5. Other chapters contain additional presentation and disclosure requirements pertaining to instruments and transactions discussed in those chapters.

5.12.20 Balance sheet



Excerpt from Regulation S-X Rule 5-02

Balance Sheets

The following is the text of Regulation S-X Rule 5-02, Balance Sheets (17 CFR 210.5-02).

The purpose of this rule is to indicate the various line items and certain additional disclosures which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the balance sheets or related notes filed for the persons to whom this article pertains (see § 210.4–01(a))...

Non-Redeemable Preferred Stocks.

28. Preferred stocks which are not redeemable or are redeemable solely at the option of the issuer. State on the face of the balance sheet, or if more than one issue is outstanding state in a note, the title of each issue and the dollar amount thereof. Show also the dollar amount of any shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. State on the face of the balance sheet or in a note, for each issue, the number of shares authorized and the number of shares issued or outstanding, as appropriate (see § 210.4–07). Show in a note or separate statement the changes in each class of preferred shares reported under this caption for each period for which a statement of comprehensive income is required to be filed. (See also § 210.4–08(d).)

Common Stocks.

29. Common stocks. For each class of common shares state, on the face of the balance sheet, the number of shares issued or outstanding, as appropriate (see § 210.4–07), and the dollar amount thereof. If convertible, this fact should be indicated on the face of the balance sheet. For each class of common shares state, on the face of the balance sheet or in a note, the title of the issue, the number of shares authorized, and, if convertible, the basis of conversion (see also § 210.4–08(d)). Show also the dollar amount of any common shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. Show in a note or statement the changes in each class of common shares for each period for which a statement of comprehensive income is required to be filed.

Other Stockholders' Equity.

30. Other stockholders' equity.

- a. Separate captions shall be shown for
 - (1) additional paid-in capital,
 - (2) other additional capital and
 - (3) retained earnings (i) appropriated and (ii) unappropriated. (See § 210.4–08(e)), and
 - (4) accumulated other comprehensive income.

Note 1 to Paragraph 30.(a). Additional paid-in capital and other additional capital may be combined with the stock caption to which it applies, if appropriate.

- b. For a period of at least 10 years subsequent to the effective date of a quasi-reorganization, any description of retained earnings shall indicate the point in time from which the new retained earnings dates and for a period of at least three years shall indicate, on the face of the balance sheet, the total amount of the deficit eliminated.

Noncontrolling Interests

31. Noncontrolling interests in consolidated subsidiaries. State separately in a note the amounts represented by preferred stock and the applicable dividend

requirements if the preferred stock is material in relation to the consolidated equity.



Excerpt from Regulation S-X Rule 4-07

Discount on Shares

The following is the text of Regulation S-X Rule 4-07, Discount on Shares (17 CFR 210.4-07).

Discount on shares, or any unamortized balance thereof, shall be shown separately as a deduction from the applicable account(s) as circumstances require.

The following sections in this chapter address balance sheet presentation requirements for equity.

- Section 5.3.50: presentation of notes receivable received in exchange for issuance of equity shares and share subscriptions receivable.
- Question 5.6.50: presentation of dividends on preferred shares.
- Section 5.7: presentation of stock distributions that are treated as stock splits.
- Section 5.8.20: presentation of treasury shares.

Chapter 7 provides guidance related to the presentation and disclosures for redeemable preferred shares classified as temporary equity.

Further, Regulation S-X requires an SEC registrant to provide separate line items for each of the following on its balance sheet:

Balance sheet item	Additional balance sheet presentation requirements
<p>Nonredeemable preferred shares classified in permanent equity – i.e. preferred shares that are either:</p> <ul style="list-style-type: none"> — not subject to mandatory redemption requirements; or — whose redemption is solely at issuer’s option 	<ul style="list-style-type: none"> — Title and dollar amount (if more than one issue is outstanding, these may be stated in a note) — Dollar amount of shares subscribed but unissued, with a deduction for related subscriptions receivable (see also section 5.3.50). <p>Further, the following are disclosed either on the balance sheet or in the notes:</p> <ul style="list-style-type: none"> — for each issue, the number of shares authorized, issued or outstanding, as appropriate. — changes in each class of preferred shares for each period for which a statement of comprehensive income is required to be filed (see also section 5.12.30). <p>[S-X Rule 5-02.28]</p>
Common shares	<ul style="list-style-type: none"> — For each class, the number of shares issued or outstanding, as appropriate, and dollar amount. — If convertible, that fact is stated.

Balance sheet item	Additional balance sheet presentation requirements
	<ul style="list-style-type: none"> — Dollar amount of shares subscribed but unissued, with a deduction for related subscriptions receivable (see also section 5.3.50). <p>Further, the following are disclosed either on the balance sheet or in the notes:</p> <ul style="list-style-type: none"> — for each class, the title and dollar amount, number of shares authorized, and the basis of conversion (if convertible). — changes in each class of common shares for each period for which a statement of comprehensive income is required to be filed (see also section 5.12.30). <p>[S-X Rule 5-02.29]</p>
APIC	<ul style="list-style-type: none"> — Each of these items may be stated separately or be combined with the share caption to which it applies
Other additional capital	
Retained earnings	<ul style="list-style-type: none"> — Appropriated and unappropriated retained earnings are stated separately. — Additional presentation and disclosure requirements apply for at least 10 years after a quasi-reorganization. <p>[S-X Rule 5-02.30(a)(3)]</p>
AOCI	
NCI	<p>If amounts represented by preferred shares are material in relation to consolidated equity, disclosure in the notes is required of the amounts and the applicable dividend requirements. [S-X Rule 5-02.31]</p>

Discounts. Unamortized discounts on any shares are shown separately as a deduction from the applicable account on an SEC registrant’s balance sheet. [S-X Rule 4-07]

 **Question 5.12.10**
What disclosures are made for treasury shares?

Interpretive response: An entity discloses the following about treasury shares: [505-10-50-3]

- class of shares – e.g. common, preferred; or if multiple issues, specify the issue;
- carrying basis and cost (if basis is other than cost); and
- number of shares held.



Question 5.12.20

Can subordinated debt be presented in the equity section of the balance sheet?



Excerpt from SAB Topic 4.A

Subordinated Debt

Facts: Company E proposes to include in its registration statement a balance sheet showing its subordinate debt as a portion of stockholders' equity.

Question: Is this presentation appropriate?

Interpretive Response: Subordinated debt may not be included in the stockholders' equity section of the balance sheet. Any presentation describing such debt as a component of stockholders' equity must be eliminated. Furthermore, any caption representing the combination of stockholders' equity and only subordinated debts must be deleted.

Interpretive response: No. Subordinated debt cannot be presented in the equity section of a balance sheet or described as a component of equity. Further, an entity must not include a caption on the balance sheet that combines shareholders' equity and subordinated debt. [SAB Topic 4.A]

5.12.30 Statement of changes in shareholders' equity



Excerpt from Regulation S-X Rule 3-04

Changes in Other Stockholders' Equity and Noncontrolling Interests

The following is the text of Regulation S-X Rule 3-04, Changes in Other Stockholders' Equity and Noncontrolling Interests (17 CFR 210.3-04).

An analysis of the changes in each caption of stockholders' equity and noncontrolling interests presented in the balance sheets shall be given in a note or separate statement. This analysis shall be presented in the form of a reconciliation of the beginning balance to the ending balance for each period for which a statement of comprehensive income is required to be filed with all significant reconciling items described by appropriate captions with contributions from and distributions to owners shown separately. Also, state separately the adjustments to the balance at the beginning of the earliest period presented for items which were retroactively applied to periods prior to that period. With respect to any dividends, state the amount per share and in the aggregate for each class of shares. Provide a separate schedule in the notes to the financial statements that shows the effects of any changes in the registrant's ownership interest in a subsidiary on the equity attributable to the registrant.



Excerpt from ASC 505-10

50-1 This Section provides guidance on the disclosure requirements associated with the separate accounts comprising shareholders' equity and the specific outstanding securities issued by an entity.

50-2 If both financial position and results of operations are presented, disclosure of changes in the separate accounts comprising shareholders' equity (in addition to retained earnings) and of the changes in the number of shares of equity securities during at least the most recent annual fiscal period and any subsequent interim period presented is required to make the financial statements sufficiently informative. Disclosure of such changes may take the form of separate statements or may be made in the basic financial statements or notes thereto.

Subtopic 505-10 requires an entity to explain changes in equity accounts during the period if it presents both a balance sheet and income statement. These explanations must include disclosure of changes in the number of shares of equity securities during at least the most recent annual fiscal period and any subsequent interim period presented. Most entities provide a statement of changes in shareholders' equity to comply with this requirement, although an entity instead can disclose these changes in the notes. [\[505-10-50-2\]](#)

Regulation S-X also requires an entity to disclose an analysis of changes in each equity caption in either a separate statement or in the notes. Its requirements are more detailed than those in Subtopic 505-10. The regulation requires a reconciliation of the beginning balance to the ending balance for each period for which an income statement is required to be filed. All significant reconciling items need to be described by appropriate captions. [\[S-X Rule 3-04\]](#)

The main components of this reconciliation are summarized as follows. [\[S-X Rule 3-04\]](#)

Reconciling item	Comments
Contributions from and distributions to owners	Show contributions separately from distributions.
Retrospectively applied items	Separately state the adjustments to the beginning balance of the earliest period presented for retroactively applied items.
Dividends	State amount per share and in the aggregate for each class of shares.
Effects of changes in registrant's ownership interest in a subsidiary	Provide a separate schedule in the notes to the financial statements that shows the effects of any changes in the registrant's ownership interest in a subsidiary on the equity attributable to the registrant.

Chapter 7 provides guidance related to the presentation and disclosures for redeemable preferred shares classified as temporary equity.

5.12.40 Other disclosure requirements



Excerpt from Regulation S-X Rule 4-08

General Notes to Financial Statements

The following is the text of Regulation S-X Rule 4-08, General Notes to Financial Statements (17 CFR 210.4-08).

If applicable to the person for which the financial statements are filed, the following shall be set forth on the face of the appropriate statement or in appropriately captioned notes. The information shall be provided for each statement required to be filed, except that the information required by paragraphs (b), (c), (d), (e) and (f) of this section shall be provided as of the most recent audited balance sheet being filed and for paragraph (j) of this section as specified therein. When specific statements are presented separately, the pertinent notes shall accompany such statements unless cross-referencing is appropriate.

- e. Restrictions which limit the payment of dividends by the registrant.
 - (1) Describe the most significant restrictions on the payment of dividends by the registrant, indicating their sources, their pertinent provisions, and the amount of retained earnings or net income restricted or free of restrictions.
 - (2) Disclose the amount of consolidated retained earnings which represents undistributed earnings of 50 percent or less owned persons accounted for by the equity method.
 - (3) The disclosures in paragraphs (e)(3)(i) and (ii) of this section shall be provided when material.
 - (i) Describe the nature of any restrictions on the ability of consolidated subsidiaries and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances (i. e., borrowing arrangements, regulatory restraints, foreign government, etc.)
 - (ii) Disclose separately the amounts of such restricted net assets for unconsolidated subsidiaries and consolidated subsidiaries as of the end of the most recently completed fiscal year.



Excerpt from ASC 505-10

50-3 An entity shall explain, in summary form within its financial statements, the pertinent rights and privileges of the various securities outstanding. Examples of information that shall be disclosed are dividend and liquidation preferences, **participation rights**, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares or terms that may change conversion or exercise prices (excluding standard antidilution provisions). An entity shall disclose within its financial statements the number

of shares issued upon conversion, exercise, or satisfaction of required conditions during at least the most recent annual fiscal period and any subsequent interim period presented. An entity also shall disclose within the financial statements actual changes to conversion or exercise prices that occur during the reporting period (excluding changes due to standard antidilution provisions).

> Securities with Preferences

50-5 In addition, an entity shall disclose both of the following within its financial statements (either on the face of the statement of financial position or in the notes thereto):

- a. The aggregate or per-share amounts at which preferred stock may be called or is subject to redemption through sinking-fund operations or otherwise
- b. The aggregate and per-share amounts of arrearages in cumulative preferred dividends.



Excerpt from ASC 505-30

> Disclosures Relating to State Laws

50-2 State laws may effect an entity's repurchase of its own outstanding common stock. If state laws relating to an entity's repurchase of its own outstanding common stock restrict the availability of retained earnings for payment of dividends or have other effects of a significant nature, those facts shall be disclosed.

There are several additional disclosures about equity instruments and transactions required, either on the face of the applicable statement or in the notes.

All securities outstanding [505-10-50-3]

Rights and privileges of each class of outstanding equity shares (see Question 5.12.30).

Number of shares issued upon conversion, exercise or satisfaction of required conditions during at least the most recent annual fiscal period and any subsequent interim period presented.

Actual changes to conversion or exercise prices that occurred during the reporting period. No disclosure is necessary if a change is due to standard anti-dilution provisions in the contract.

Preferred shares [505-10-50-5]

Aggregate per-share amounts at which shares may be called or are subject to redemption through sinking fund operations or otherwise.

Aggregate and per-share amounts of arrearages in cumulative preferred dividends.

See also Question 5.12.50.

Dividend restrictions

Dividend restrictions or other effects of a significant nature resulting from state laws relating to treasury share transactions. [505-30-50-2]

Disclosures required by Reg S-X: [S-X Rule 4-08]

- Description of the most significant restrictions, indicating their sources, pertinent provisions, and the amount of retained earnings or net income restricted or free of restrictions.
- The amount of consolidated retained earnings that represents undistributed earnings of 50% or less owned persons accounted for by the equity method.
- When material, the following:
 - the nature of any restrictions on the ability of consolidated subsidiaries and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances – i.e. borrowing arrangements, regulatory restraints, foreign government, etc.
 - disclosed separately, the amounts of such restricted net assets for unconsolidated subsidiaries and consolidated subsidiaries as of the end of the most recently completed fiscal year.

**Question 5.12.30**

What types of rights and privileges are disclosed for equity shares?

Interpretive response: An entity discloses: [505-10-50-3, 50-5]

- the legal name of each type of share;
- the par value (stated or assigned) per share;
- shares reserved;
- the existence of redemption features or repurchase agreements;
- changes to conversion prices that occur during the reporting period (excluding changes due to standard anti-dilutive provisions). Disclosure of the terms that may change the conversion or exercise price of an instrument include, but are not limited to, changes that have occurred or may occur upon the triggering of a down-round feature; and
- the amount of dividends per share and in the aggregate for each class of shares.

Further, we believe an entity should disclose significant restrictions on dividends, even if it is not an SEC registrant.

See paragraph 505-10-50-3 for additional examples of rights and privileges that are required to be disclosed.



Question 5.12.50

What additional disclosures apply to convertible preferred stock?**Excerpt from ASC 505-10**

> Convertible Preferred Stock

50-12 The objective of the disclosure about convertible preferred stock is to provide users of financial statements with:

- a. Information about the terms and features of convertible preferred stock
- b. An understanding of how those instruments have been reported in an entity's statement of financial position and statement of financial performance
- c. Information about events, conditions, and circumstances that can affect how to assess the amount of timing of an entity's future cash flows related to those instruments.

50-13 To comply with the general disclosure requirements of paragraph 505-10-50-3, an entity shall explain the pertinent rights and privileges of each outstanding instrument, including, but not limited to, the following information:

- a. Number of shares issued and par value
- b. Dividends
- c. Conversion or exercise prices or rates and number of shares into which the instrument is potentially convertible
- d. Pertinent dates, such as conversion date(s)
- e. Parties that control conversion rights
- f. Manner of settlement upon conversion and any alternative settlement methods, such as cash, shares, or a combination of cash and shares
- g. Terms that may change conversion or exercise prices, number of shares to be issued, or other conversion rights and the timing of those rights (excluding standard antidilution provisions)
- h. Liquidation preference required by paragraph 505-10-50-4 and unusual voting rights
- i. Other material terms and features of the instrument that are not listed above.

50-14 An entity shall provide the following incremental information for **contingently convertible instruments** or the instruments that are described in paragraphs 505-10-05-6 through 05-7:

- a. Events or changes in circumstances that would adjust or change the contingency or would cause the contingency to be met
- b. Information on whether the shares that would be issued if the contingently convertible securities were converted are included in the calculation of diluted earnings per share (EPS) and the reasons why or why not
- c. Other information that is helpful in understanding both the nature of the contingencies and the potential impact of conversion.

50-15 An entity shall disclose the amount of dividends declared for each period for which a statement of financial performance is presented, in addition to the disclosures required by paragraph 505-10-50-5.

50-16 An entity shall disclose the following as of the date of the latest statement of financial position presented:

- a. Changes to conversion or exercise prices that occur during that reporting period other than changes due to standard antidilution provisions
- b. Events or changes in circumstances that occur during the reporting period that cause conversion contingencies to be met or conversion terms to be significantly changed
- c. The number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period.

50-17 If a conversion option is accounted for as a derivative in accordance with Subtopic 815-15, an entity shall provide disclosures in accordance with Topic 815 for the conversion option in addition to the disclosures required by the guidance in this Section, if applicable.

50-18 An entity shall disclose the following information about derivative transactions entered into in connection with the issuance of convertible preferred stock within the scope of this Subtopic regardless of whether such derivative transactions are accounted for as assets, liabilities, or equity instruments:

- a. The terms of those derivative transactions (including the terms of settlement)
- b. How those derivative transactions relate to the instruments within the scope of this Subtopic
- c. The number of shares underlying the derivative transactions
- d. The reasons for entering into those derivative transactions.

Interpretive response: Topic 505 requires the incremental disclosures identified above for convertible preferred stock.

See also discussion of disclosure requirements in chapter 9 of KPMG Handbook, [Earnings per share](#).

Presentation of equity by publicly held limited partnerships



Excerpt from SAB Topic 4.F

Limited Partnerships

Facts: There exist a number of publicly held partnerships having one or more corporate or individual general partners and a relatively larger number of limited partners. There are no specific requirements or guidelines relating to the presentation of the partnership equity accounts in the financial statements. In addition, there are many approaches to the parallel problem of relating the results of operations to the two classes of partnership equity interests.

Question: How should the financial statements of limited partnerships be presented so that the two ownership classes can readily determine their relative participations in both the net assets of the partnership and in the results of its operations?

Interpretive Response: The equity section of a partnership balance sheet should distinguish between amounts ascribed to each ownership class. The equity attributed to the general partners should be stated separately from the equity of the limited partners, and changes in the number of equity units authorized and outstanding should be shown for each ownership class. A statement of changes in partnership equity for each ownership class should be furnished for each period for which an income statement is included.

The income statements of partnerships should be presented in a manner which clearly shows the aggregate amount of net income (loss) allocated to the general partners and the aggregate amount allocated to the limited partners. The statement of income should also state the results of operations on a per unit basis.

A partnership's 'equity' is its partnership interests. In a limited partnership there are two ownership classes: general partnership interests and limited partnership interests. SAB Topic 4.F contains SEC requirements for presenting the ownership interests in a publicly traded limited partnership's financial statements. [SAB Topic 4.F]

Balance sheet	Separately present general and limited partnership interests, including changes in the number of equity units authorized and outstanding for each class.
Statement of changes in partnership equity	Provide for each ownership class for each period for which an income statement is included.
Income statement	Clearly show the net income or loss allocated to the general partners and the amount allocated to limited partners, on both an aggregate and per-share basis.

Limited partnership syndication fees

Limited partnership syndication fees are recorded as a reduction to partners' contributed capital, similar to the treatment of stock issuance costs that are clearly and directly attributable to the sale of shares.

6. Distinguishing liabilities from equity

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6.1 How the standard works

Topic 480 establishes classification and measurement guidance for three classes of financial instruments with characteristics of both liabilities and equity. It requires an entity to classify the following instruments as liabilities when they meet the following criteria.

	Mandatorily redeemable financial instruments requirements	Obligations to repurchase issuer's equity shares by transferring assets requirements	Certain obligations to issue a variable number of shares requirements
Freestanding	General requirement for all financial instruments under Topic 480 (section 6.3)		
Does not meet a scope exception	Mandatorily redeemable financial instruments are excluded from one or more provisions of Topic 480 if one of the three scope exceptions applies (section 6.4.20)	No scope exceptions specific to this instrument class	
Types of instruments	Must be issued in the form of shares (Questions 6.2.50 and 6.2.60)	Any financial instrument other than an outstanding share (section 6.5.20)	Instruments issued in the form of shares and other financial instruments
Reflects an obligation of the issuer	Must be an unconditional obligation on a specified or determinable date or upon an event certain to occur (section 6.4.30 and Question 6.4.40)	At inception, embodies a conditional or an unconditional obligation to repurchase the issuer's equity shares, or is indexed to such an obligation (section 6.5.30)	Unconditional obligation if the instrument is in the form of shares. May be a conditional or an unconditional obligation for other financial instruments. (Question 6.6.10)
Settlement	Must be redeemed by transferring issuer's assets	Issuer is required or may be required to transfer assets in settlement (section 6.5.30)	The monetary value of the financial instrument must or may be settled by issuing a variable number of issuer's equity shares (sections 6.6.30 – 6.6.50)
Monetary value			Based solely or predominantly on one of three criteria: <ul style="list-style-type: none"> — Fixed amount known at inception (section 6.6.30) — Variations in something other than FV of issuer's equity shares (section 6.6.40) — Variations inversely related to FV changes in issuer's equity shares (section 6.6.50)

While Topic 480 establishes guidance for how an issuer classifies certain financial instruments with characteristics of both liabilities and equity, its primary focus is when an issuer is required to classify a financial instrument in its scope as a liability.

Key terms specific to Topic 480

These key terms are used throughout chapter 6 and have definitions specific to Topic 480. While the terms are found in other accounting standards, the following definitions do not necessarily apply outside of the Topic.

Key terms in Topic 480		
Issuer		
The entity that issued a financial instrument or may be required under the terms of a financial instrument to issue its equity shares.		
Obligations		
An obligation is a conditional or unconditional duty or responsibility to transfer assets or to issue equity shares to another entity.		
Conditional obligation	Unconditional obligation	
The issuer is not obligated to perform unless a specified condition is satisfied.	The issuer is obligated to perform either currently, or after the passage of time regardless of future events.	
Settlement methods		
Physical settlement	Net-cash settlement	Net-share settlement
The holder delivers the stated amount of cash or other financial instruments to the issuer; and the issuer delivers the stated number of shares or other financial instruments or nonfinancial items to the holder. This is also referred to as gross settlement.	The party with a loss delivers to the party with a gain cash equal to the gain.	The party with a loss delivers to the party with a gain shares with a fair value equal to the gain.
Option contract		
A contract that gives the holder the right, but not the obligation, to buy or sell an underlying (e.g. an issuer's equity shares) in exchange for an agreed-upon fee. If the option holder does not exercise the option within a specified period, the option contract expires.		
Call option	Put option	
An option contract that gives the holder the right, but not the obligation, to buy an underlying at a specified price on or before a specified date.	An option contract that gives the holder the right, but not the obligation, to sell an underlying at a specified price on or before a specified date.	

Key terms in Topic 480

Forward contract

A contract to purchase or sell a specific quantity of an underlying (e.g. an issuer's equity shares) at a specified price with delivery and settlement at a specified future date.

Monetary value

The fair value of the cash, equity shares or other instruments that the issuer is obligated to convey to the holder at the settlement date under specified market conditions. For certain financial instruments, Topic 480 requires considering whether monetary value would remain fixed or would vary in response to changes in market conditions. How the monetary value of a financial instrument varies in response to changes in market conditions depends on the nature of the arrangement, including the form of settlement.

Shares, equity shares, issuer's equity shares

Shares	Equity shares	Issuer's equity shares
<p>Various forms of ownership interests, which may or may not take the legal form of securities (e.g. partnership or LLC interests), as well as other interests, including those that are liabilities in substance but not in form. Shares may be classified as liabilities or equity on the balance sheet of the issuer.</p>	<p>Shares that are classified as equity on the balance sheet of the issuer.</p>	<p>Equity shares of any subsidiary whose financial statements are included in the consolidated financial statements of the parent.</p>

6.2 Scope of Topic 480: General principles

6.2.10 Overview



Excerpt from ASC 480-10

05-1 The Codification contains separate Topics for liabilities and equity, including a separate Topic for debt. The Distinguishing Liabilities from Equity Topic contains only the Overall Subtopic. This Subtopic establishes standards for how an **issuer** classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. Section 480-10-25 requires that an issuer classify a **financial instrument** that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an **obligation** of the issuer.

10-1 The objective of this Subtopic is to require issuers to classify as liabilities (or assets in some circumstances) three classes of **freestanding financial instruments** that embody **obligations** for the issuer.

> Entities

15-2 The guidance in the Distinguishing Liabilities from Equity Topic applies to all entities.

An issuer classifies an issued freestanding financial instrument that is in the scope of Topic 480 as a liability (or an asset in some circumstances). There are different recognition criteria for each class of financial instrument in the scope of Topic 480. However, a financial instrument must first satisfy two general requirements to be in its scope:

- be a freestanding financial instrument (see section 6.2.20); and
- reflect an obligation of the issuer (see section 6.2.30).

Sections 6.2 and 6.3 analyze these general requirements when determining whether an instrument is in the scope of Topic 480. Section 6.2.30 further explains how the type of obligation (conditional versus unconditional) affects whether and which of the three classes of financial instruments in Topic 480 an instrument may be in scope of. Section 6.2.40 addresses the concept of nonsubstantive, minimal features, which are disregarded in applying Topic 480.



Question 6.2.10

Which entities are in the scope of Topic 480?

Interpretive response: Any entity that issues freestanding financial instruments in the scope of Topic 480 applies its guidance. This includes public business entities, SEC registrants, and nonpublic entities. [480-10-15-2]

The issuer, as that term is used in Topic 480, is the entity that issued a financial instrument (e.g. an outstanding common or preferred share), or may be

required under the terms of a financial instrument to issue its equity shares (e.g. certain obligations to issue a variable number of shares). In addition, an entity that enters into a contract that obligates it to repurchase its own shares by transferring assets (e.g. a forward purchase contract that is settled in cash) is also considered an issuer under Topic 480 because it issued the shares underlying the contract. [480-10 Glossary]

Section 6.4.20 addresses scope exceptions for some entities from the guidance for mandatorily redeemable financial instruments under Topic 480.



Question 6.2.20

Does Topic 480 address when an issuer should classify a financial instrument as equity?

Interpretive response: No. Topic 480 does not address when an issuer should classify a financial instrument as equity. It addresses only when to classify certain financial instruments as liabilities, and the measurement and disclosure requirements for those instruments.

If a financial instrument does not meet Topic 480's general requirements – i.e. it is not a freestanding instrument that reflects an obligation of the issuer – or the instrument does not meet the relevant criteria for the three classes of financial instruments under Topic 480, it is not necessarily classified as equity. It is simply considered to be outside the scope of Topic 480 and the issuer applies other accounting guidance to determine how to classify the instrument on its balance sheet – e.g. the SEC's temporary equity guidance discussed in chapter 7.

6.2.20 Freestanding financial instrument



Excerpt from ASC 480-10

20 Glossary

Financial Instrument

Cash, evidence of an ownership interest in an entity, or a contract that both:

- a. Imposes on one entity a contractual obligation either:
 1. To deliver cash or another financial instrument to a second entity
 2. To exchange other financial instruments on potentially unfavorable terms with the second entity.
- b. Conveys to that second entity a contractual right either:
 1. To receive cash or another financial instrument from the first entity
 2. To exchange other financial instruments on potentially favorable terms with the first entity.

The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. Some contractual rights (contractual obligations) that are financial instruments may not be recognized in financial statements—that is, they may be off-balance-sheet—because they fail to meet some other criterion for recognition.

For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.

Freestanding Financial Instrument

A financial instrument that meets either of the following conditions:

- a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.
- b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

> Instruments

15-5 Because paragraph 480-10-15-3 limits the scope of this Topic to freestanding instruments, this Topic does not apply to a feature embedded in a **financial instrument** that is not a derivative instrument in its entirety.

25-2 For purposes of applying paragraph 815-10-15-74(a) in analyzing an embedded feature as though it were a separate instrument, paragraphs 480-10-25-4 through 25-14 shall not be applied to the embedded feature. Embedded features shall be analyzed by applying other applicable guidance.

The first general scope requirement of Topic 480 is that a financial instrument must be freestanding. A freestanding financial instrument is a financial instrument that is entered into either: [\[480-10 Glossary\]](#)

- separate and apart from any of the issuer's other financial instruments or equity transactions; or
- in conjunction with another transaction but is legally detachable and separately exercisable.

Guidance about how to make this determination is discussed in section 6.3.

Topic 480 does not apply to a feature embedded in a financial instrument that is not accounted for as a derivative instrument in its entirety. Instead, the entire instrument is evaluated to determine whether it is in the scope of Topic 480. [\[480-10-15-5\]](#)



Question 6.2.40

Why are embedded features outside the scope of Topic 480?

Interpretive response: Applying the classification guidance in Topic 480 to features embedded in financial instruments that are not accounted for as derivative instruments in their entirety would essentially mandate separate accounting for some embedded features that are precluded from separate accounting because they are not considered derivatives under Topic 815.

As a result, Topic 480 does not apply to embedded features. See section 9.2 for discussion about Subtopic 815-10 scope exceptions for embedded derivatives amended by Topic 480.

6.2.30 An obligation of the issuer



Excerpt from ASC 480-10

20 Glossary

Equity Shares

Equity shares refers only to shares that are accounted for as equity.

Issuer

The entity that issued a financial instrument or may be required under the terms of a financial instrument to issue its equity shares.

Issuer's Equity Shares

The equity shares of any entity whose financial statements are included in the consolidated financial statements.

Shares

Shares includes various forms of ownership that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. (Business entities have interest holders that are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are encompassed by the descriptive term owners. Equity of business entities is, thus, commonly known by several names, such as owners' equity, stockholders' equity, ownership, equity capital, partners' capital, and proprietorship. Some entities [for example, mutual organizations] do not have stockholders, partners, or proprietors in the usual sense of those terms but do have participants whose interests are essentially ownership interests, residual interests, or both.)

05-2 All of the following are examples of an obligation:

- a. An entity incurs a conditional obligation to **transfer** assets by issuing (writing) a put option that would, if exercised, require the entity to

repurchase its **equity shares** by **physical settlement**. (Further, an instrument that requires the issuer to settle its obligation by issuing another instrument [for example, a note payable in cash] ultimately requires settlement by a transfer of assets.)

b. An entity incurs a conditional obligation to transfer assets by issuing a similar contract that requires or could require **net cash settlement**.

c. An entity incurs a conditional obligation to issue its equity shares by issuing a similar contract that requires **net share settlement**.


05-3 In contrast, by issuing **shares** of stock, an entity generally does not incur an obligation to redeem the shares, and, therefore, that entity does not incur an obligation to transfer assets or issue additional equity shares. However, some issuances of stock (for example, mandatorily redeemable preferred stock) do impose obligations requiring the issuer to transfer assets or issue its equity shares.

The second general scope requirement of Topic 480 is that a financial instrument must reflect an obligation of the issuer – a fundamental aspect of a liability. [480-10-05-1]

Under Topic 480, an instrument reflects an obligation of the issuer if it conditionally or unconditionally obligates the issuer to settle the instrument by transferring assets or by issuing its equity shares. [480-10-05-1 – 05-2]

Shares issued do not generally create an obligation of the issuer but may in certain situations. Under Topic 480, shares issued that create an obligation for the issuer could be either: [480-10-05-1 – 05-3]

- a mandatorily redeemable share (see section 6.4); or
- an obligation to issue a variable number of shares – e.g. share-settled debt (see section 6.6).

 **Question 6.2.50**
What is considered an outstanding share under Topic 480?

Interpretive response: The definition of a share in Topic 480 is quite broad (see section 6.1). While common shares and preferred shares are well-known forms of ownership, shares also include other forms that may not take the legal form of securities, and other interests, including those that are liabilities in substance but not in form. [480-10 Glossary]

Owners and types of ownership interests	
These:	May also be called:
Interest holders	Shareholders
	Partners
	LLC members
	Proprietors

Owners and types of ownership interests	
These:	May also be called:
	Investors
	Cooperative members
Equity	Owners' equity
	Stockholders' equity
	Ownership
	Equity capital
	Partners' capital
	LLC members' interests
	Proprietorship
	Cooperative members' interests

Some business entities (e.g. mutual organizations) do not have stockholders, partners, LLC members or proprietors in the usual sense. Instead, they have participants whose interests are essentially ownership interests and/or retained interests. These interests fall within the Topic 480 definition of a share. This broad definition applies only to Topic 480 – not necessarily to other Topics. [480-10 Glossary]



Question 6.2.60

Under Topic 480, does a parent consider a subsidiary's equity shares as its own in its consolidated financial statements?

Interpretive response: Yes, but only when applying Topic 480. For financial statements issued by a consolidated group of entities, the issuer's equity shares include the equity shares of any entity whose financial statements are included in its consolidated financial statements. [480-10 Glossary]

For example, if a subsidiary issues a financial instrument to a third party that is classified in its separate financial statements as a liability under Topic 480, the parent company classifies that instrument as a liability in its consolidated financial statements.

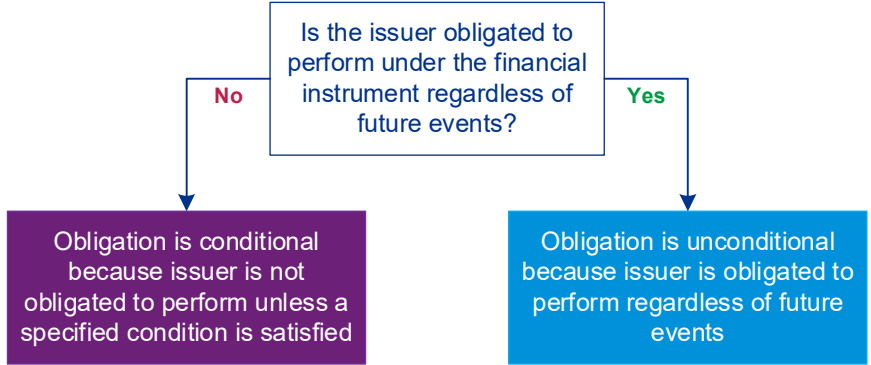
However, if a subsidiary issues a financial instrument that is outside the scope of Topic 480, the definition of an issuer's equity shares in Topic 480 does not change the application of other accounting guidance to that instrument. For example, if the subsidiary issues shares that are outside the scope of Topic 480 and are classified as equity in the financial statements of the subsidiary, they would be classified as NCI in the consolidated financial statements. See section 6.4.20 for additional discussion about NCI. [480-10 Glossary]

Question 6.2.70
Can a cancellable contract reflect an obligation of the issuer?

Interpretive response: No. If both parties can cancel a contract at any time then the contract does not meet the definition of a financial instrument and is not in the scope of Topic 480. It does not concurrently impose a contractual obligation on one party and convey a contractual right to the other. [480-10-05-2, 480-10 Glossary]

Question 6.2.80
When is an obligation conditional vs unconditional?

Interpretive response: An issuer may need to determine whether its obligation to perform under a financial instrument is unconditional or is subject to satisfying one or more conditions. This distinction is important because while unconditional obligations may fall into any of the three classes of instruments in the scope of Topic 480, conditional obligations may fall into only some of them. Sections 6.4 – 6.6 apply these concepts to the three categories of instruments in Topic 480.



How to determine whether the issuer is obligated to perform regardless of future events may depend on the instrument’s method of settlement. [480-10-05-2]

For example, ABC Corp. enters into a forward purchase contract with DEF Corp. that requires ABC to repurchase its own equity shares held by DEF at a future date.

If the forward contract requires	Then
Physical settlement	The obligation is unconditional because the forward contract requires ABC to repurchase its own equity shares for cash regardless of future events.

If the forward contract requires	Then
Net-cash settlement	The obligation is conditional because ABC will only be required to transfer assets to DEF if, from its perspective, the contract is in a loss position at settlement. If the contract is in a gain position at settlement from ABC's perspective, it will receive assets.
Net-share settlement	The obligation is conditional because ABC will only be required to net-share settle the contract if, from its perspective, the contract is in a loss position at settlement. If the contract is in a gain position at settlement from ABC's perspective, it is not obligated to transfer assets or its own shares.



Example 6.2.10 Conditional obligation – put option

ABC Corp. owns equity shares of DEF Corp. DEF writes a put option to ABC that allows ABC to sell the equity shares back to DEF.

The put option is a conditional obligation for DEF because ABC may allow the option to expire unexercised. It is conditioned on whether ABC will exercise the option regardless of its method of settlement. [480-10-05-2]



Question 6.2.85 Is a conditional contract an obligation if it requires a transfer of assets only upon the occurrence of an event that the issuer controls?

Interpretive response: No. If a contract requires the issuer to transfer assets only upon the occurrence of an event that the issuer controls, the issuer controls the ability to avoid transferring assets. Therefore, the contract does not represent an obligation.

However, if the event occurs and the issuer becomes obligated to transfer assets, the contract would be an obligation. Further, a conditional contract that is not an obligation under Topic 480 may represent an outstanding instrument that is in the scope of Subtopic 815-40; see Question 8.2.110.

6.2.40 Nonsubstantive or minimal features



Excerpt from ASC 480-10

• • > Option to Redeem Shares Embedded in a Minimal Host

55-41 An entity issues one share of preferred stock (with a par amount of \$100), paying a small dividend, and embeds in it an option allowing the holder to put the preferred share along with 100,000 shares of the issuer's common stock (currently trading at \$50) for a fixed price of \$45 per share in cash. The preferred stock host is judged at inception to be minimal and would be disregarded under paragraph 480-10-25-1 in applying the classification provisions of this Subtopic. Therefore, under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement), that instrument would be analyzed as a written put option in its entirety, classified as a liability, and measured at fair value.

An issuer disregards any feature of a financial instrument that is nonsubstantive or minimal when applying Topic 480. To distinguish substantive, nonminimal features from nonsubstantive or minimal features, an issuer needs to consider all the instrument's terms and other relevant facts and circumstances. [480-10-1, 25-1, 55-41]



Question 6.2.90

Why does an issuer disregard nonsubstantive or minimal features?

Interpretive response: An issuer disregards nonsubstantive or minimal features when applying Topic 480 to address the possibility that it might insert a nonsubstantive or minimal feature into a financial instrument to avoid liability classification. The FASB's example in paragraph 480-10-55-41 (see above) of an option to redeem shares embedded in a minimal host illustrates this concept. [480-10-25-1, 55-41]



Question 6.2.100

What does an issuer evaluate to determine whether a feature is nonsubstantive or minimal?

Interpretive response: Determining whether a feature is nonsubstantive or minimal requires an entity to exercise significant judgment. Topic 480 provides little guidance in this area; however, the overall intent is to prevent circumvention of its requirements by embedding an otherwise freestanding instrument into a minimal host. [480-10-25-1, 55-41]

We believe the reason for including the feature in the instrument is an important consideration. If there is no ascertainable business rationale for

including the feature, other than to obtain a specific accounting outcome, it should be ignored.



Question 6.2.110

When does an issuer evaluate whether a feature is nonsubstantive or minimal?

Interpretive response: An issuer evaluates whether a feature is nonsubstantive or minimal at an instrument's inception. It does not reassess the feature at a later date, except when a conditionally redeemable instrument becomes mandatorily redeemable because: [480-10-25-1, 25-5]

- the event has occurred;
- the condition is resolved; or
- the event becomes certain to occur.



Example 6.2.20

Nonsubstantive or minimal – conversion option

On March 1, Year 1, Issuer issues Series B convertible redeemable preferred shares for \$1,000 per share. Each Series B share:

- pays 8% cumulative dividends;
- is convertible into Issuer's common shares at Holder's option at a conversion price equal to the then-current liquidation preference divided by \$200 per share; or
- if not converted by January 1, Year 4, is mandatorily redeemable for cash for an amount equal to the then-current liquidation preference of the share.

Issuer issued Series A redeemable preferred shares two months earlier, also for \$1,000 per share. The Series A shares are identical to the Series B shares except they do not have a conversion feature.

The following additional facts are relevant.

- Over the past several years, Issuer's common share price has fluctuated between \$10 and \$20 per share.
- Issuer's common share price on March 1, Year 1 is \$12 per share.
- The volatility of Issuer's common share price is low.

Issuer evaluates the Series B shares as of their issuance date to determine whether the conversion feature is substantive. Based on this evaluation, Issuer concludes that it is not likely that the common share price will reach the \$200 conversion price before the January 1, Year 4 mandatory redemption date. It reaches this conclusion by considering the current price and historical price range and the low volatility of its common shares.

Further, the Series B holders ascribed little or no incremental value to the conversion option because they paid the same price for nonconvertible preferred shares with substantially the same features two months earlier.

Issuer concludes that the conversion option in the Series B shares is nonsubstantive. Therefore, it disregards the conversion option when determining whether the Series B shares are in the scope of Topic 480.



Example 6.2.30

Nonsubstantive or minimal – subsequent decline in share price

Assume the same facts as in Example 6.2.20, except for the following.

- The conversion price of each convertible redeemable preferred share is equal to the then-current liquidation preference divided by \$15 per share instead of \$200 per share.
- The Series A redeemable preferred shares pay 12% cumulative dividends.
- The Series B holders ascribed value to the conversion option because they paid the same price per share for nonconvertible preferred shares two months earlier and receive a higher dividend rate (12% instead of 8%).

Issuer evaluates the Series B shares as of their issuance date to determine whether the conversion feature is substantive. It determines that there is a more than remote chance that the common share price will reach the \$15 conversion price before the January 1, Year 4 mandatory redemption date. It reaches this conclusion by considering the current price and historical price range along with the low volatility of its common shares.

Issuer concludes that the conversion option in the Series B shares is substantive. Therefore, it considers the conversion option when determining whether the Series B shares are in the scope of Topic 480.

Subsequent dramatic decline in share price

Because of circumstances unforeseen at the Series B preferred shares' issuance date, Issuer's common share price declined dramatically throughout Year 3. The average daily closing price of its common shares during the year was \$3 per share and its closing price at the end of the year was \$1 per share.

Issuer determines that the conversion feature in its Series B redeemable preferred shares is now nonsubstantive because the conversion price (\$15 per share) is high in relation to the current common share price. Issuer no longer expects its common share price to increase above \$15 before the January 1, Year 4 mandatory redemption date.

Despite these revised expectations, Issuer does not reevaluate its initial determination that the conversion option is substantive. See Question 6.2.110 for additional discussion.



Example 6.2.40
Nonsubstantive or minimal – embedded call option

On March 1, Year 1, Issuer issues preferred shares for \$1,000 per share to a group of investors. Issuer may choose to call the preferred shares for cash on January 1, Year 4 for an amount equal to the then-current liquidation preference of the shares.

Over the past several years, Issuer issued similar instruments to the same group of investors. In each case, Issuer exercised the call option.

Further, according to Issuer’s corporate charter:

- the only type of perpetual equity instrument Issuer is permitted to issue is common shares; and
- Issuer is required to redeem any issued equity instrument other than common shares at the earliest possible date.

The preferred shares have an embedded call option. Although a call option itself may be substantive, Issuer first needs to assess the option in light of the corporate charter. Because the shares issued are preferred shares, Issuer’s corporate charter requires Issuer to redeem them at the earliest date possible, which is January 1, Year 4.

Therefore, Issuer concludes that in substance the embedded call feature has no optionality and therefore is nonsubstantive. As a result, Issuer disregards the call option when determining whether preferred shares are in the scope of Topic 480.

6.2.50 Registration payment arrangements



Question 6.2.120
Are registration payment arrangements in the scope of Topic 480?



Excerpt from ASC 825-20

20 Glossary

Registration Payment Arrangement

An arrangement with both of the following characteristics:

- a. It specifies that the issuer will endeavor to do either of the following:
 1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S.

- Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period
2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).
- b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).



Excerpt from ASC 480-10

- > Registration Payment Arrangements

15-8A The guidance in this Topic does not apply to the following instruments:

- a. **Registration payment arrangements** within the scope of Subtopic 825-20.

Interpretive response: No. An entity may issue financial instruments (e.g. equity shares, warrants, debt instruments) that are subject to a registration payment arrangement. Registration payment arrangements in the scope of Subtopic 825-20 are outside the scope of Topic 480. This is the case even if they meet the requirements under Topic 480 to be classified as liabilities. [480-10-15-8A, 825-20-05-1]

6.3 Freestanding financial instruments and embedded features

6.3.10 Freestanding financial instruments



Excerpt from ASC 480-10

- > Instruments

15-3 The guidance in the Distinguishing Liabilities from Equity Topic applies to any freestanding **financial instrument**, including one that has any of the following attributes:

- a. Comprises more than one option or forward contract
- b. Has characteristics of both a liability and equity and, in some circumstances, also has characteristics of an asset (for example, a forward contract to purchase the **issuer's equity shares** that is to be net cash settled). Accordingly, this Topic does not address an instrument that has only characteristics of an asset.

15-4 For example, an instrument that consists of a written put option for an issuer's equity shares and a purchased call option and nothing else is a freestanding financial instrument (paragraphs 480-10-55-18 through 55-20 provide examples of such instruments). That freestanding financial instrument embodies an **obligation** to repurchase the issuer's equity shares and is subject to the requirements of this Topic.

25-1 The guidance in this Section shall be applied to a **freestanding financial instrument** in its entirety. Any nonsubstantive or minimal features shall be disregarded in applying the classification provisions of this Section. Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

- > Financial Instruments Involving Multiple Components

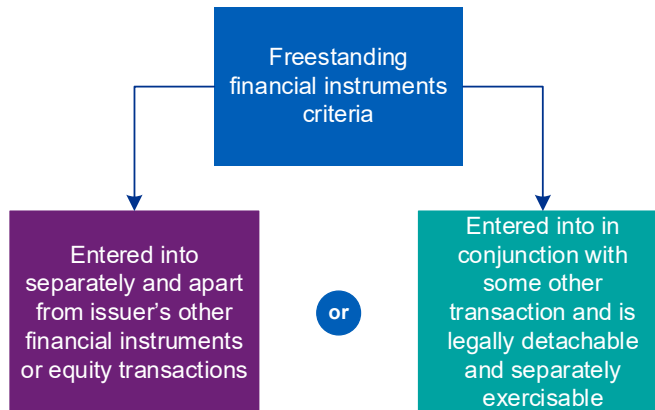
55-29 The implementation guidance that follows addresses financial instruments involving multiple components that embody (or are indexed to) an obligation to repurchase the issuer's shares and that may require settlement by transferring assets. Some freestanding financial instruments composed of more than one option or forward contract embodying obligations require or may require settlement by transfer of assets. Paragraphs 480-10-15-3 through 15-4 state that the provisions of this Subtopic apply to freestanding financial instruments, including those that comprise more than one option or forward contract, and paragraphs 480-10-25-4 through 25-14 shall be applied to a freestanding financial instrument in its entirety. Under paragraphs 480-10-25-8 through 25-12, if a freestanding instrument is composed of a written call option and a written put option, the existence of the written call option does not affect the classification. Unlike the application of paragraph 480-10-25-14, applying paragraphs 480-10-25-8 through 25-12 does not involve making any judgments about predominance among obligations or contingencies.

55-30 Consider, for example, a puttable warrant that allows the holder to purchase a fixed number of the issuer's shares at a fixed price that also is puttable by the holder at a specified date for a fixed monetary amount that the holder could require the issuer to pay in cash. The warrant is not an outstanding share and therefore does not meet the exception for outstanding shares in paragraphs 480-10-25-8 through 25-12. As a result, the example puttable warrant is a liability under those paragraphs, because it embodies an obligation indexed to an obligation to repurchase the issuer's shares and may require a transfer of assets. It is a liability even if the repurchase feature is conditional on a defined contingency in addition to the level of the issuer's share price.

Topic 480 applies to freestanding financial instruments in their entirety. This includes instruments that comprise more than one option or forward contract. Therefore, determining whether a financial instrument is freestanding is critical.

Because of the lack of interpretive guidance about what constitutes a freestanding instrument, this determination is one of the most challenging aspects of Topic 480. [480-10-15-3, 25-1]

Under Topic 480, an instrument needs to meet one of two criteria to be considered freestanding. [480-10 Glossary]



Despite the longtime and frequent use of the concept of ‘freestanding’ in the context of a derivative instrument, in our experience it has been difficult applying that concept in practice to more complex instruments. This difficulty results from the lack of comprehensive guidance on the definition of a freestanding financial instrument, and when to account for two financial instruments as a single unit. Sections 6.3.20 and 6.3.30 address many of the issues.

See section 6.10 for examples of how complex instruments with multiple components are analyzed as freestanding instruments under Topic 480.

Question 6.3.10
Are option contracts and option features embedded in other contracts in the scope of Topic 480?

Interpretive response: Features embedded in a financial instrument that are not separated from the instrument are not in the scope of Topic 480 because they are not freestanding financial instruments (see section 6.2.20).

For example, a written put option embedded in an issuer’s shares is not subject to Topic 480. In contrast, a freestanding written put option on an issuer’s shares is subject to Topic 480 (see Example 6.5.40).

Other guidance (e.g. the embedded derivative guidance in Topic 815) may require an issuer to separate a financial instrument into components and account for each component individually (see Question 6.3.80).



Question 6.3.20

How is a financial instrument with multiple components analyzed under Topic 480?

Interpretive response: All written put options and forward purchase contracts on an entity's equity shares are in the scope of Topic 480 if they have a single, required settlement method – either physical, net-cash or net-share settlement. These instruments may be in the scope of Topic 480 even though they could expire unexercised or may not result in an obligation for the issuer at the settlement date. [480-10-25-8 – 25-10, 25-12, 25-14]

Some financial instruments may have multiple components, such as a freestanding financial instrument that comprises a written call option and a written put option. An entity applies Topic 480's classification requirements to such an instrument in its entirety – evaluating both the written call option's potential settlement and the written put option's potential settlement. If either of these potential settlements would result in the instrument being in the scope of the guidance for obligations to repurchase the issuer's equity shares by transferring assets, the entire instrument is in the scope of Topic 480. [480-10-55-18]

This is because the guidance for obligations to repurchase the issuer's equity shares by transferring assets uses the term 'may require' to describe affected instruments. Therefore, if an instrument that is not an outstanding share has a possible settlement outcome in the guidance for obligations to repurchase the issuer's equity shares by transferring assets, the instrument in its entirety is in the scope of Topic 480 regardless of the other potential settlement outcomes. [480-10-25-8 – 25-10, 25-13, 55-29 – 55-30]

6.3.20 Separately and apart from criterion

A financial instrument is freestanding if the issuer enters into the instrument separately and apart from its other financial instruments or equity transactions. [480-10 Glossary]



Question 6.3.30

If multiple instruments are issued to the same counterparty, can one or more of the instruments meet the 'separately and apart from' criterion?

Interpretive response: Yes, if certain conditions are met. When an issuer issues multiple financial instruments to the same counterparty (or related party group), we believe the following conditions need to exist to conclude that the issuer entered into one or more of those instruments separately and apart from the other financial instruments or equity transactions, and therefore the instruments are freestanding:

- the instruments are contractually distinct – i.e. each instrument is documented separately; and

- there is a reasonable period of time between the issuance of the financial instrument being evaluated and the issuance of the other financial instrument(s) to the same counterparty (or related party group).

If an issuer concludes that a financial instrument is not entered into separately and apart from other financial instruments or equity transactions, the instrument may still be considered freestanding. However, in that case the issuer evaluates whether the instrument entered into in conjunction with some other transaction can be legally detached and separately exercised. See section 6.3.30 for discussion about performing that evaluation. [480-10 Glossary]



Question 6.3.40

If multiple instruments are issued on the same day to different counterparties, can one or more of the instruments meet the 'separately and apart from' criterion?

Interpretive response: Except in rare circumstances, we believe two or more contractually distinct instruments issued to separate, unrelated counterparties are entered into 'separately and apart from' other financial instruments or equity transactions. Therefore, these instruments are considered freestanding. This is the case even if they are issued contemporaneously or within a very short time period.



Example 6.3.10

Issuance of common shares and put option to different counterparties

On March 1, Year 1, Issuer issues 100 common shares to Holder for \$1,000. Holder can sell all or part of the 100 common shares and is not restricted from purchasing more of Issuer's common shares in the future.

Also on March 1, Year 1, Issuer writes a put option to Investment Bank that allows Investment Bank to sell 100 Issuer common shares to Issuer for \$1,000 at any time during the next five years. Investment Bank is unrelated to Holder.

Issuer issued the common shares and the put option to separate, unrelated counterparties. Therefore, we believe the put option is entered into 'separately and apart from' the common shares. This is the case even though the put option and common shares were issued on the same date.

Each instrument is considered to be freestanding. As a result, Issuer determines whether each instrument individually is in the scope of Topic 480.

6.3.30 Legally detachable and separately exercisable criterion

If a financial instrument is detachable and separately exercisable, it is freestanding even if it is issued in conjunction with another transaction. [480-10 Glossary]



Question 6.3.50

How does an issuer determine whether an instrument is legally detachable and separately exercisable?

Interpretive response: An important factor an issuer considers in evaluating whether a financial instrument can be legally detached and separately exercised is whether it is possible that the remaining financial instrument(s) would continue to exist unchanged when the other financial instrument is exercised. Generally, we believe it is not necessary for the financial instrument being evaluated to be transferable to third parties for that instrument to be considered freestanding.



Question 6.3.60

How does settlement affect whether the instrument is considered legally detachable and separately exercisable?

Interpretive response: We believe an instrument is legally detachable and separately exercisable if the remaining instrument(s) would continue to exist unchanged if the instrument under consideration was exercised (see Question 6.3.50). To apply this principle, an issuer needs to analyze how the instrument settles.

Net settlement

When a financial instrument is issued with one or more other financial instruments and either the issuer or holder can net-cash or net-share settle the instrument, we believe that instrument is legally detachable and separately exercisable. This is because the remaining instrument(s) may continue to exist unchanged when the other instrument is exercised – e.g. if the net settlement alternative is elected.

Physical settlement

When a financial instrument is issued with one or more other financial instruments and the issuer is required to physically settle the instrument, the issuer performs an analysis of the contracts and the facts and circumstances of the transaction. We believe an instrument is legally detachable and separately exercisable if:

- it is not linked to a specifically identified underlying – e.g. a put option that identifies the specific shares to be delivered at settlement; or

- its exercise does not cause the expiration or exercise of the remaining instrument(s).

This is because the remaining instrument(s) may continue to exist unchanged.

For many instruments that require physical settlement in an issuer's own shares (e.g. physically settled written put options and forward purchase contracts), the shares or other financial instruments transferred at settlement are fungible.

The party required to deliver shares in physical settlement of a financial instrument (e.g. the holder of a written put option) can use the shares it already holds when it purchased the put option. Alternatively, it could deliver shares it subsequently purchases from the issuer or another entity. In both cases, the physically settled financial instrument is not linked to specifically identified shares. Therefore, because the shares received with the option could continue to exist unchanged after the option is exercised, the option is considered legally detachable and separately exercisable. In contrast, if the holder of the put option must settle it by physically delivering specifically identified shares or financial instruments, the put option and the underlying shares are not legally detachable and separately exercisable.

If the issuer issues shares that it is required to redeem under related agreements so that the redemption relates to those specific shares, it views the shares and the separate redemption agreement as a single unit. Therefore, the specific shares are mandatorily redeemable instruments (see section 6.4). An issuer should view these instruments as a single unit if the redemption agreement relates to specific underlying shares. We believe this guidance is consistent with our view that an issuer would not consider these financial instruments legally detachable and separately exercisable. [\[480-10-15-7C, 25-4 - 25-6\]](#)



Question 6.3.70

Can a written put option on shares issued be considered legally detachable and separately exercisable if the shares and the written put option are issued to the same party?

Background: An issuer may enter into an agreement to sell its equity shares to another party and simultaneously enter into a separate agreement with the same party that allows the equity share purchaser to put back (sell) to the issuer the equity shares that it purchased from the issuer.

Interpretive response: Yes. The put option is considered legally detachable and separately exercisable if:

- the equity shares and put option are in separate contracts; and
- the put option can be net-cash or net-share settled while the equity shares remain outstanding. [\[480-10 Glossary\]](#)

If these conditions are met, the put option is considered legally detachable and separately exercisable because the equity shares may continue to exist unchanged when the put option is exercised – e.g. if a net-share settlement alternative is elected. [\[480-10 Glossary\]](#)

Physical settlement

The put option may be considered legally detachable and separately exercisable even if physical settlement is required, as long as the option holder is not required to deliver specifically identified equity shares. This is the case when, at settlement, the holder can deliver shares subsequently purchased from the issuer or another entity. In this case, the equity shares issued to the option holder may continue to exist unchanged when the put option is exercised. The fact that the option holder could choose to deliver the equity shares associated with the option is not relevant. The analysis requires that it is possible that those equity shares could continue to exist unchanged.

A consolidated subsidiary may concurrently enter into a separate contract whereby a purchaser of the subsidiary's equity shares is permitted to sell (put) the shares back to the subsidiary. The subsidiary may enter into these types of arrangements with a third-party shareholder of that subsidiary's equity (i.e. an NCI holder).

If the put option is legally detachable and separately exercisable, it is a freestanding financial instrument for purposes of both:

- the parent's consolidated financial statements; and
- the subsidiary's separate financial statements.


The put option is legally detachable and separately exercisable if, under the facts and circumstances, the equity shares issued to the purchaser may remain unchanged if the purchaser exercises the put option. [\[480-10 Glossary\]](#)

An issuer considers the factors below related to instruments on or indexed to the subsidiary's equity shares together with other relevant facts and circumstances when determining whether a feature indexed to a subsidiary's equity shares is legally detachable and separately exercisable. See further discussion of certain arrangements where features are indexed to the equity shares of a consolidated subsidiary in section 6.10.

The factors in the following table are helpful indicators of whether a feature is legally detachable and separately exercisable. They may need to be evaluated in combination or with additional relevant factors when making the determination.

Feature	Suggests feature is legally detachable and separately exercisable	Suggests feature is <u>not</u> legally detachable and separately exercisable
Put option permits net settlement	The subsidiary's equity shares continue to exist unchanged.	Not applicable.
Put option requires physical settlement	The subsidiary's equity shares that must be delivered at settlement are not specifically identified in the put option contract or related agreements.	The subsidiary's equity shares that must be delivered at settlement are specifically identified in the put option contract or related agreements.
Subsidiary has multiple classes of equity shares on a stand-alone basis	Some of the holders of a specific class of equity shares do not have a put right.	All holders of a specific class of equity shares are entitled to exercise the put right.

Feature	Suggests feature is legally detachable and separately exercisable	Suggests feature is <u>not</u> legally detachable and separately exercisable
Subsidiary has one class of equity shares on a stand-alone basis	The put option is conveyed to a limited subset of holders of the subsidiary's equity shares – e.g. only the minority shareholders are entitled to exercise the put right.	The put option is conveyed to all holders of the subsidiary's equity shares – e.g. including the parent company.
Party required to settle the put option	The parent, instead of the subsidiary, must settle the put option that is indexed to the subsidiary's equity shares.	The parent is not required to settle the put option that is indexed to the subsidiary's equity shares. The subsidiary must settle the put option.
Rights of the new holder of the subsidiary's equity shares	If the subsidiary's equity shares that are subject to the put feature are transferred, the put rights are not required to be transferred to the new holder of the shares – e.g. the original holder may retain the put feature or it may be forfeited when the underlying shares are transferred.	If the subsidiary's equity shares that are subject to the put feature are transferred, the put rights must be transferred concurrently to the new holder of the shares.

 **Example 6.3.20**
Common shares and option contract

On March 1, Year 1, Issuer issues 100 of its common shares to Holder for \$1,000. Holder can sell all or part of the 100 common shares and is not restricted from purchasing more of Issuer's common shares in the future.

Also on March 1, Year 1, Issuer writes a put option contract to Holder that allows Holder to sell 100 of Issuer's common shares to Issuer for \$1,000 at any time during the next five years. The put option requires physical settlement.

To determine whether the financial instrument is freestanding, Issuer analyzes whether the common shares and option contract:

- are transacted separate and apart from each other (see Question 6.3.30); or
- are legally detachable and separately exercisable.

'Separate and apart from' criterion

The first condition is met because the common shares and option contract are in separate documents. The second condition is not met because Issuer issued the common shares and option contract concurrently to the same counterparty. Therefore, the option contract does *not* meet the 'separately and apart from' criterion.

'Legally detachable and separately exercisable' criterion

The common shares and put option are in separate contracts and physical settlement is required. Holder is not required to deliver specifically identified shares to Issuer. At settlement, Holder may deliver the shares it currently holds, or shares subsequently purchased from Issuer or another entity. Therefore, the put option is considered legally detachable and separately exercisable because the specific equity shares that Holder holds may continue to exist unchanged if Holder exercises the put option (see Question 6.3.60).

Because the put option is considered legally detachable and separately exercisable, Issuer considers each instrument to be freestanding. As a result, Issuer determines whether each instrument individually is in the scope of Topic 480.



Example 6.3.30

Common shares and option contract – specifically identified equity shares

On March 1, Year 1, Issuer issues 100 of its common shares to Holder for \$1,000. The common share certificates are numbered from 201 to 300.

Also on March 1, Year 1, Issuer writes a put option contract to Holder that allows Holder to sell the specific 100 shares numbered 201 to 300 to Issuer for \$1,000 at any time in the future. If Holder sells the common shares, the option contract is required to be sold concurrently to the same counterparty. The put option requires physical settlement.

Issuer performs the same analysis as in Example 6.3.20. In both examples, the equity shares and put option are in separate contracts and physical settlement is required.

However, in this example, Holder is required to deliver specifically identified equity shares to Issuer at settlement – numbered 201 to 300. The put option is not considered legally detachable and separately exercisable because the specific equity shares presently held by Holder will not continue to exist unchanged if Holder exercises the put option – i.e. the specific equity shares are directly linked to the exercise of the option contract.

Issuer concludes that the instruments are not freestanding and are viewed under Topic 480 as a single unit – a puttable share. Puttable shares are conditional obligations and not in the scope of Topic 480. See section 6.4.30 for further discussion about conditional obligations and chapter 7 about SEC guidance on temporary equity.



Example 6.3.40

Common shares and option contract – settlement alternatives

On March 1, Year 1, Issuer issues 100 of its common shares to Holder for \$1,000. Holder can sell all or part of the 100 common shares and is not restricted from purchasing more of Issuer's common shares in the future.

Also on March 1, Year 1, Issuer writes a put option contract to Holder that allows Holder to sell 100 of Issuer's common shares to Issuer for \$1,000 at any time during the next five years. The put option may be physically settled, net-cash settled or net-share settled.

Issuer performs the same analysis as in Examples 6.3.20 and 6.3.30. In all three examples, the equity shares and put option are in separate contracts. However, in Examples 6.3.20 and 6.3.30 physical settlement is required, but in this example the put option may be physically settled, net-cash or net-share settled.

Financial instruments that permit net-cash or net-share settlement are considered legally detachable and separately exercisable (see Question 6.3.60). In this example, the put option can be net settled, so it is considered legally detachable and separately exercisable because the specific equity shares that Holder holds may continue to exist unchanged when the put option is exercised.

Therefore, Issuer considers each instrument to be freestanding. As a result, Issuer determines whether each instrument individually is in the scope of Topic 480.

6.3.40 Combining separate freestanding instruments



Excerpt from ASC 480-10

> Prohibition on Combining Freestanding Financial Instruments

25-15 A freestanding financial instrument that is within the scope of this Subtopic shall not be combined with another freestanding financial instrument in applying paragraphs 480-10-25-4 through 25-14 unless combination is required under the provisions of Topic 815. For example, a freestanding written put option that is classified as a liability under this Subtopic shall not be combined with an outstanding equity share.

If two or more instruments are considered freestanding under Topic 480, they are not combined unless Topic 815 requires them to be combined. For example, an issuer does not combine a freestanding liability-classified written put option with an outstanding equity share. [480-10-25-15]



Question 6.3.80

If Topic 815 does not require financial instruments to be combined, could they nevertheless be combined under Topic 480?

Interpretive response: No. Freestanding financial instruments that are in the scope of Topic 480 are not combined with other freestanding instruments unless Topic 815 requires combining them. [480-10-25-15, FAS 150.B50–B51]

The prohibition on combining financial instruments when applying Topic 480 prevents an entity from circumventing its requirements. For example, if an issuer combined a freestanding instrument that is a liability under Topic 480 with a freestanding instrument that is equity under other guidance, the issuer could consider the combined instrument to fall outside the scope of Topic 480. If that were the case, the issuer would not recognize a liability, nor any gains or losses resulting from fair value changes in that liability.



Question 6.3.90

When does Topic 815 require two or more instruments to be combined?

Interpretive response: Topic 815 requires that if two or more separate transactions are entered into in an attempt to circumvent its requirements, an issuer combines them and determines if the combined unit meets the definition of a derivative.

To determine whether there was an intent to circumvent the requirements of Topic 815 (see Question 6.3.80), an issuer considers the following indicators in the aggregate and, if present, views the transaction as a unit: [815-10-15-9]

- the transactions were entered into contemporaneously and in contemplation of one another;
- the transactions were executed with the same counterparty (or structured through an intermediary);
- the transactions relate to the same risk; and
- there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.



Question 6.3.100

How does an issuer account for two or more instruments that are combined under Topic 815?

Interpretive response: If an issuer determines that two or more separate transactions were entered into in an attempt to circumvent the requirements of Topic 815, it views the transactions as a single arrangement for the purposes of determining whether Topic 815 applies (see Question 6.3.90).

- **Single arrangement in scope of Topic 815.** If the single arrangement meets the definition of a derivative and does not qualify for one of the scope exceptions from derivative accounting, the issuer accounts for the arrangement as a derivative asset or liability under Topic 815.
- **Single arrangement not in scope of Topic 815.** If the single arrangement does not meet the definition of a derivative or if one of the scope exceptions from derivative accounting applies, the issuer evaluates the combined instruments as a single unit to determine whether it is in the scope of Topic 480. [480-10-25-15]



Question 6.3.110

Does an issuer need to determine whether purchased and written options are considered a single forward contract?

Interpretive response: Yes. An issuer may need to address whether purchased and written options are considered separate option contracts or a single forward contract when applying Topic 815. See the combination of options discussion throughout chapters 5 and 6 of KPMG Handbook, [Derivatives and hedging](#).

If the options do not meet the criteria for combining under Topic 815, they are accounted for separately and analyzed under Topic 480. [480-10-25-15]

6.4 Mandatorily redeemable financial instruments

6.4.10 Overview



Excerpt from ASC 480-10

20 Glossary

Mandatorily Redeemable Financial Instrument

Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

> Mandatorily Redeemable Financial Instruments

25-4 A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

25-5 A **financial instrument** that embodies a conditional obligation to redeem the instrument by **transferring** assets upon an event not certain to occur

becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

25-6 In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:

- a. A term extension option
- b. A provision that defers redemption until a specified liquidity level is reached
- c. A similar provision that may delay or accelerate the timing of a mandatory redemption.

25-7 If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this Subtopic. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

The first class of instruments that require liability classification under Topic 480 is mandatorily redeemable instruments; see overview in section 6.1.

A redeemable financial instrument is an instrument that may be redeemed at the issuer’s option (e.g. a callable instrument), the holder’s option (e.g. a puttable instrument), by contract (e.g. an instrument that matures on a specific date), or a combination thereof. Topic 480 uses the term ‘mandatorily redeemable financial instrument’ to describe a financial instrument that includes a contractual requirement to redeem the instrument; they are referred to throughout this section as mandatorily redeemable instruments.

A share that meets the requirements of a mandatorily redeemable instrument is classified as a liability, unless one or more of the following apply. [480-10-15-7A – 15-7E, 25-4]

Exception	Reference
It is redeemable only upon the issuer’s liquidation or termination (liquidation exception)	See section 6.4.20 and Question 6.4.140
It qualifies for the nonpublic entity exception	See section 6.4.20
It qualifies for the NCI exception	See section 6.4.20

Question 6.4.10
How does an issuer determine whether an instrument is accounted for as a mandatorily redeemable instrument under Topic 480?

Interpretive response: The following diagram summarizes the criteria for determining whether an instrument is a mandatorily redeemable instrument under Topic 480. If an instrument does not meet the criteria, it may still be in the scope of another class of financial instrument under Topic 480 (see Questions 6.5.10 and 6.6.10). If the instrument is not in the scope of Topic 480, an entity considers other US GAAP, including the requirements related to temporary equity (see chapter 7) and on contracts in an entity’s own equity (see chapter 8).

	Mandatorily redeemable financial instrument requirements
Freestanding financial instrument	General requirement under Topic 480(section 6.3)
Does not meet a scope exception	Mandatorily redeemable financial instruments are excluded from one or more provisions of Topic 480 if one of the three scope exceptions applies: (a) if redemption is only upon issuer’s liquidation or termination, (b) for non-SEC registrants, (c) mandatorily redeemable NCI (section 6.4.20)
Types of instruments	Must be issued in the form of shares (Questions 6.2.50 and 6.2.60)
Reflects on obligation of the issuer	Must be an unconditional obligation on a specified or determinable date or upon an event certain to occur (section 6.4.30 and Question 6.4.40)
Settlement	Must be redeemed by transferring issuer’s assets

The diagram incorporates the two general requirements for financial instruments to be in the scope of Topic 480 (see section 6.2.10) – the financial instrument must be freestanding and reflect an obligation of the issuer. However, there are nuances related to the second general requirement that are specific to mandatorily redeemable financial instruments (see section 6.4.30). Further, an instrument also must meet the remaining requirements in the diagram to be accounted for as a mandatorily redeemable financial instrument, as discussed in section 6.4. [480-10-25-4 – 25-7]



Question 6.4.30

How do mandatorily redeemable instruments differ from nonredeemable common and preferred shares?

Interpretive response: Mandatorily redeemable instruments leave the issuer no discretion to avoid sacrificing its assets in the future.

In contrast, nonredeemable common or preferred shares do not obligate the issuer to sacrifice its assets (or reacquire its shares). Although nonredeemable common or preferred shares may pay dividends, the issuer has the discretion – but not the obligation – to do so. Therefore, nonredeemable common and preferred shares lack an essential characteristic of a liability. Redeemable equity instruments are discussed in chapter 7.



Question 6.4.40

How does an issuer determine whether a share contains a determinable redemption date or an event that is certain to occur?

Interpretive response: The issuer examines the share’s underlying and related documents (e.g. governing documents of the issuer) to determine whether there is a specified or determinable date or an event that is certain to occur upon which the issuer is required to redeem the share by transferring its assets. Examples of events certain to occur include death, termination or retirement of any person that holds the instrument. [\[480-10 Glossary\]](#)

A probability analysis is not relevant when determining whether a share contains a determinable date or an event that is certain to occur.



Example 6.4.10 Preferred shares

On January 1, Year 1, Issuer issues preferred shares that it must redeem for \$1,000 on December 31, Year 5.

The preferred shares are mandatorily redeemable. This table analyzes the preferred shares using the diagram in Question 6.4.10.

Mandatorily redeemable criteria	Satisfied?
Freestanding	✓
Does not meet a scope exception for certain mandatorily redeemable instruments (see section 6.4.20)	✓
Outstanding share	✓

Mandatorily redeemable criteria	Satisfied?
Unconditionally obligates Issuer to redeem instrument	✓
Requires redemption by transferring Issuer's assets at specified or determinable date(s) or upon event that is certain to occur	✓



Question 6.4.50#

Does an issuer consider term extension options and similar features when determining whether a share is mandatorily redeemable?

Interpretive response: No. A share may allow the issuer to extend the term, defer redemption until a specified liquidity level is reached, or have similar provisions that may delay or accelerate the timing of its required redemption. Although these features may affect the timing of redemption, they do not affect whether redemption is mandatory. Therefore, an issuer does not consider these features when determining whether a share is mandatorily redeemable. [480-10-25-6]

If the instrument is not in the scope of Topic 480, an issuer may be required to evaluate any term extension options and similar features under other applicable accounting guidance (e.g. Topics 815 and 470). [480-10-25-6]



Question 6.4.60

Can a share be considered mandatorily redeemable because of increasing-rate or other features that could economically compel redemption?

Background: Some preferred shares pay low or no dividends early in their term and then pay dividends at an increasing rate. These instruments are referred to as 'increasing-rate preferred shares'. [505-10-S99-7]

Interpretive response: No. A feature that increases the interest or dividend rate on an instrument does not by itself make the instrument mandatorily redeemable. This is the case even if the increasing-rate feature economically compels the issuer so that there is an 'implied mandatory redemption date'. When an unconditional obligation for redemption is absent, a share is not mandatorily redeemable even if it is probable that the issuer will redeem the share.

While an increasing-rate feature alone does not make an instrument mandatorily redeemable, an increasing-rate preferred share may have other features that make it a mandatorily redeemable instrument and is analyzed under Topic 480 as outlined in the diagram in Question 6.4.10. [480-10-25-4 – 25-7]

See discussion in chapter 5 about increasing-rate preferred shares classified as equity.



Question 6.4.70

Can shares be considered mandatorily redeemable if the share itself does not indicate a required redemption date?

Interpretive response: It depends. If the shares are issued with a redemption agreement (e.g. a side agreement) that relates to those specific underlying shares, the shares are mandatorily redeemable instruments if the applicable criteria are met. An issuer also considers whether the redemption feature may be nonsubstantive or minimal and disregarded, similar to the analysis in Example 6.2.20 [480-10-15-7C]

6.4.20 Scope exceptions for mandatorily redeemable financial instruments



Excerpt from ASC 480-10

• • > Certain Mandatorily Redeemable Financial Instruments of Nonpublic Entities

15-7A The classification, measurement, and disclosure guidance in this Subtopic does not apply to mandatorily **redeemable financial instruments** that meet both of the following:

- a. They are issued by nonpublic entities that are not **Securities and Exchange Commission (SEC) registrants**.
- b. They are mandatorily redeemable, but not on fixed dates or not for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index.

15-7B Mandatorily redeemable financial instruments issued by an SEC registrant are not eligible for the scope exception in paragraph 480-10-15-7A, even if the entity meets the definition of a **nonpublic entity**.

15-7C Some entities have issued shares that are required to be redeemed under related agreements. If the shares are issued with a redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable. If an entity with such shares and redemption agreement is a nonpublic entity that is not an SEC registrant, those mandatorily redeemable shares meet the scope exception in paragraph 480-10-15-7A if they meet the conditions specified in that paragraph.

15-7D Although the disclosure requirements of this Subtopic do not apply for those mandatorily redeemable instruments of certain nonpublic companies that meet the scope exception in paragraph 480-10-15-7A, the requirements of

Subtopic 505-10 still apply. In particular, paragraph 505-10-50-3 requires information about the pertinent rights and privileges of the various securities outstanding, which includes mandatory redemption requirements. Paragraph 505-10-50-11 also requires disclosure of the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.

- > Certain Mandatorily Redeemable Noncontrolling Interests

15-7E The guidance in this Subtopic does not apply to mandatorily redeemable noncontrolling interests (of all entities, public and nonpublic) as follows:

- a. The classification and measurement provisions of this Subtopic do not apply to mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by the subsidiary, under the only upon liquidation exception in paragraphs 480-10-25-4 and 480-10-25-6, but would be classified as liabilities by the parent in consolidated financial statements.
- b. The measurement provisions of this Subtopic do not apply to other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable noncontrolling interest. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other predecessor literature (for example, in paragraph 480-10-S99-3A) continues to apply.

15-7F All public entities as well as nonpublic entities that are SEC registrants with mandatorily redeemable noncontrolling interests subject to the classification and measurement scope exception in paragraph 480-10-15-7E are required to follow the disclosure requirements in paragraphs 480-10-50-1 through 50-3 as well as disclosures required by other applicable guidance.

An instrument may meet the definition of a mandatorily redeemable financial instrument under Topic 480 but may be exempt from the scope of the classification, measurement or disclosure requirements of Topic 480.

 **Question 6.4.80**
What are the three scope exceptions for mandatorily redeemable financial instruments?

Interpretive guidance: There are three scope exceptions to the mandatorily redeemable financial instruments guidance. Under these exceptions, an instrument may meet the criteria to be accounted for as a mandatorily redeemable financial instrument but is exempt from one or more of the requirements of Topic 480.

The following table summarizes the scope exceptions. [480-10-15-7A – 15-7F]

Exceptions to certain mandatorily redeemable financial instrument requirements under Topic 480				
Exception	Reason for exception	Entities who apply the exception	Instruments outside scope of Topic 480	Exempted from
Non-SEC registrants	To address general questions and concerns about applying the requirements of mandatorily redeemable financial instruments for non-SEC registrants. [480-10-15-7A, FSP FAS 150-3, ASU 2017-11]	Nonpublic entities that are non-SEC registrants	Mandatorily redeemable instruments that are: <ul style="list-style-type: none"> — not redeemable on a fixed date; or — not redeemable for an amount fixed or determined by reference to an interest rate index, currency index, or other external index. 	Classification Measurement Disclosure
Only upon liquidation	To address the issue that when redemption occurs only when an entity ceases to exist, it provides holders with an ownership interest like equity ownership, not a liability. [480-10-25-4, 25-6]	All entities	Instruments that are mandatorily redeemable only upon the liquidation or termination of the reporting entity.	Classification Measurement Disclosure

Exceptions to certain mandatorily redeemable financial instrument requirements under Topic 480				
Exception	Reason for exception	Entities who apply the exception	Instruments outside scope of Topic 480	Exempted from
Certain mandatorily redeemable NCI	To address the inconsistency between parent and subsidiary accounting arising when a subsidiary issues an instrument to its NCI shareholders that is redeemable only upon the subsidiary's liquidation or termination, and the parent entity cannot apply the 'only upon liquidation' exception in classifying the redeemable NCI in its consolidated financial statements (because it is not the issuer). As a result, classification of the mandatorily redeemable NCI is inconsistent between the subsidiary's stand-alone financial statements (equity) and the parent's consolidated financial statements (liability). [480-10-15-7E, FSP FAS 150-3, ASU 2017-11]	All entities: Parent's consolidated financial statements	Mandatorily redeemable NCI that are redeemable only upon the liquidation or termination of a consolidated subsidiary	Classification Measurement
			Other mandatorily redeemable NCI that were issued before November 5, 2003	Measurement
		All entities: Consolidated subsidiaries' stand-alone financial statements	Other mandatorily redeemable NCI that were issued before November 5, 2003	Measurement



Question 6.4.90

If a mandatorily redeemable financial instrument qualifies for one of the scope exceptions, does the SEC's temporary equity guidance apply?

Interpretive response: Yes. If a mandatorily redeemable instrument qualifies for a scope exception under Topic 480, an SEC registrant considers whether it needs to classify the instrument as temporary equity. An entity that qualifies for the non-SEC registrant exception may, but is not required to, consider the temporary equity guidance (see chapter 7). [\[480-10-S99-3A\]](#)

Non-SEC registrants exception



Question 6.4.100

Does Topic 480 apply to shares issued by a non-SEC registrant to its employees that must be redeemed upon the employee's death or termination?

Interpretive response: A non-SEC registrant may restrict ownership of common shares to active employees by requiring itself to redeem the shares upon an employee's death or termination, typically for the shares' then fair value. Without a non-SEC registrant exception, Topic 480 would have required those shares to be classified as liabilities because death or termination of employment is an event certain to occur. This would have caused many employee-owned companies with those provisions to not have outstanding 'equity' instruments (see Question 6.4.110).

However, those shares typically meet the requirements of the non-SEC registrant exception because at the shares' inception: [\[480-10-15-7A\]](#)

- the redemption date is not fixed because that date depends on employee deaths or terminations; and
- the redemption amount is neither fixed nor determinable by reference to an index because the issuer redeems the shares at fair value.

Therefore, generally a non-SEC registrant that issues such common shares would not classify the shares as liabilities.



Example 6.4.20

Redeemable shares issued by a non-SEC registrant

Partnership is a non-SEC registrant that has issued partnership interests that it must redeem for cash upon the:

- death of a partner;
- withdrawal of a partner from Partnership; or
- liquidation of Partnership.

The partnership agreement indicates that Partnership will be liquidated five years after inception.

The partnership interests are not in the scope of Topic 480 and are classified as equity. In this example, although the instrument does not meet the criteria for the non-SEC registrant exception, it does meet the 'only upon liquidation' exception.

Although Partnership is a non-SEC registrant, it does not qualify for the non-SEC registrant scope exception because it does not meet the two criteria – the instrument is neither:

- redeemable on a fixed date – death or withdrawal of a partner is not certain to occur before the dissolution of the partnership in five years; nor
- redeemable for a fixed or determinable amount by reference to an index.

However, because the partnership interests are mandatorily redeemable upon liquidation – certain to occur five years from inception – they meet the liquidation exception (see Question 6.4.140).



Question 6.4.110

Will a non-SEC registrant with only mandatorily redeemable shares have any accounting equity?

Interpretive response: We believe that as a result of the non-SEC registrant scope exception, it will be unusual for a nonpublic, non-SEC registrant with mandatorily redeemable shares not to have any 'equity' instruments outstanding. Therefore, the presentation guidance in Question 6.4.280 for mandatorily redeemable shares when the redemption amount is different from the book value of the shares will have limited applicability.

However, an employee-owned company that is an SEC registrant that requires all equity shares to be redeemed on the employee's death or termination of employment is one of the limited situations in which this presentation guidance is required to be applied. See section 6.7 for a discussion of presentation requirements under Topic 480. [\[480-10-45-2A – 45-2B\]](#)



Question 6.4.120

Can a broker-dealer apply the non-SEC registrant exception?

Interpretive response: No, broker-dealers cannot apply the non-SEC registrant exception. Under Section 15 of the Securities Exchange Act of 1934, most brokers and dealers must register with the SEC and are considered SEC registrants.



Question 6.4.130

How does a non-SEC registrant reflect mandatorily redeemable instruments excluded from Topic 480 in its financial statements once it becomes an SEC registrant?

Interpretive response: The SEC staff has indicated that if a non-SEC registrant applied the non-SEC registrant exception to its mandatorily redeemable instruments, and that entity files an IPO, it reflects the adoption of Topic 480 in its financial statements as if it were an SEC registrant for all periods presented. [\[480-10-15-7A, Regs Comm 04/2004\]](#)

'Only upon liquidation' exception



Question 6.4.140

When does the 'only upon liquidation' exception apply to mandatorily redeemable financial instruments?

Interpretive response:

When the liquidation date is not known

When mandatory redemption is upon liquidation of an entity, the liquidation date may not be known or even certain to occur. Until the date is known or the event becomes certain to occur, these instruments do not meet the criteria for mandatorily redeemable financial instruments and are outside the scope of Topic 480. [\[480-10-15-7A, 25-5, 480-10 Glossary\]](#)

When the liquidation date is known

A limited-life entity is an entity that is designed to be liquidated on a certain date or upon the occurrence of a certain event. The governing agreements of some partnerships, limited liability companies, real estate investment trusts and entities domiciled in certain foreign jurisdictions specify that the entity will have a limited life. [\[480-10 Glossary\]](#)

If redemption occurs only because the issuer ceases to exist, the instrument's holder will have an ownership interest similar to that of an equity owner. Therefore, when the liquidation date is known, such as in the case of a limited-life entity, the 'only upon liquidation' exception applies. [\[480-10-15-7A, 25-4, 25-6\]](#)

Under this scope exception, entities do not apply the classification, measurement or disclosure requirements of Topic 480 for instruments that meet the requirements for mandatorily redeemable financial instruments when redemption is mandatory only upon liquidation or termination of the reporting entity. [\[480-10-15-7A, 25-4, 25-6, 480-10 Glossary\]](#)



Example 6.4.30

Partnership interests redeemable upon liquidation

Partnership issues partnership interests that it must redeem for cash on December 15, Year 20. None of Partnership's governing documents (e.g. partnership agreement) specify a future dissolution or liquidation date. However, Partnership will effectively cease to exist because no partners will be left once the instruments are redeemed.

Partnership will redeem all outstanding partnership interests on December 15, Year 20, effectively dissolving itself on that date. The liquidation exception applies and Partnership does not classify the partnership interests as liabilities based on the following:

- Partnership will cease to exist upon redemption of the partnership interests; and
- Partnership's governing documents do not permit new partnership interests to be issued that would be redeemed on a date different from that of the current partners' interests.

In reaching this conclusion, Partnership carefully considered applicable state laws governing the partnership structure as well as the terms of its partnership agreement.

NCI exception

This scope exception addresses the inconsistency between subsidiary and parent reporting that arises when the subsidiary applies the 'only upon liquidation' exception. [480-10-15-7E]

See section 7.5 of KPMG Handbook, [Consolidation](#), for discussion about the interrelationship between Topic 480 and Topic 805 when accounting for mandatorily redeemable NCI in consolidated financial statements as part of a business combination.

Limited-life entities

As discussed in Question 6.4.140, the 'only upon liquidation' exception applies to limited-life entities. Example 6.4.40 examines how a parent accounts for the NCI of a consolidated subsidiary (a limited-life entity) in its consolidated financial statements.



Example 6.4.40

Reporting NCI in a limited-life entity in the parent's consolidated financial statements

Parent, a real estate developer, has a 75% interest in Partnership, which it consolidates.

The following additional facts are relevant.

- An unrelated third party owns the other 25% interest.
- Partnership will terminate no later than December 31, Year 5.
- As part of the termination procedures, Partnership's assets will be sold, liabilities will be settled and the remaining cash distributed to the partners based on their ownership interests.
- Partnership owns land and has no other assets or liabilities.
- The fair value of the land at September 30, Year 3 is \$6,000. Parent's consolidated financial statements and Partnership's separate financial statements report the land at \$1,000 (historical cost).
- The NCI in Partnership is reported by Parent as \$250.

Parent is reporting its financial statements for the three months ended September 30, Year 3.

Partnership can apply the 'only upon liquidation' exception and does not classify its mandatorily redeemable NCI as a liability. Parent cannot apply the 'only upon liquidation' exception to the NCI of its subsidiary, but it can apply the mandatorily redeemable NCI exception.

As a result, Parent does not apply the classification or measurement requirements of Topic 480 to the NCI in its consolidated financial statements at September 30, Year 3. Instead, it reports the NCI as \$250 (25% of the \$1,000 historical cost) and classifies it as equity under the mandatorily redeemable NCI exception.

Note: Parent considers the SEC temporary equity guidance for equity-classified instruments discussed in chapter 7 if it is an SEC registrant or another entity that is required to apply that guidance. Other entities may elect to apply this SEC guidance, even if they are not required to.



Question 6.4.150

Are a subsidiary and parent required to apply the disclosure requirements of Topic 480 for NCI in a limited-life entity?

Interpretive response: Yes, if either the subsidiary or parent is an SEC registrant – i.e. the disclosures apply to both entities if one of them is an SEC registrant. The disclosure requirements apply even though Topic 480's classification and measurement guidance do not apply to the NCI.

For example, an SEC registrant that consolidates a non-wholly owned limited-life partnership discloses the amount of consideration that would be paid to the NCI holders as if the partnership were terminated on the reporting date. Likewise, an SEC registrant that consolidates a non-wholly owned subsidiary in a foreign jurisdiction that specifies a termination date in its governing documents (e.g. as a matter of law) is subject to the same disclosure requirements. [480-10-15-7F]

**Question 6.4.160****Are a subsidiary and parent required to apply all requirements of Topic 480 for mandatorily redeemable NCI in the scope of Topic 480?**

Interpretive response: If an NCI is otherwise in the scope of Topic 480, the classification and measurement requirements of Topic 480 apply at both the subsidiary and parent levels. However, certain requirements of Topic 480 do not apply to NCI issued before November 5, 2003 (see Question 6.4.170). [480-10-15-7E(a)]

In addition, SEC registrants are required to comply with the disclosure requirements in Topic 480 for financial instruments representing an NCI in unlimited-life entities. For non-SEC registrants, the disclosure requirements do not apply to instruments representing an NCI in an unlimited-life entity; however, they are not prohibited from furnishing the Topic 480 disclosures. [480-10-15-7F]

**Example 6.4.50****Shares issued by an unlimited-life subsidiary**

On December 1, Year 1, Issuer issues preferred shares to an unrelated investor that require redemption on a fixed date for a fixed amount. Issuer has an unlimited life. Issuer's parent consolidates Issuer and is an SEC registrant.

The preferred shares are in the scope of Topic 480 and its classification, measurement and disclosure requirements apply in the financial statements of both Issuer and its parent.

NCI issued before November 5, 2003**Question 6.4.170****How do the classification and measurement requirements of Topic 480 apply to mandatorily redeemable NCI issued before November 5, 2003?**

Interpretive response: Mandatorily redeemable NCI that were issued before November 5, 2003 are classified as liabilities in both the subsidiary's financial statements and the parent's consolidated financial statements if the redemption could be before the subsidiary's liquidation or termination. However, because the measurement requirements of Topic 480 do not apply, both the subsidiary and parent measure the carrying amount of those instruments based on other applicable accounting guidance, such as the guidance for temporary equity (see chapter 7). [480-10-15-7E]

Under paragraph 480-10-15-7E, we believe the dividends on the mandatorily redeemable shares should be classified as interest costs in the subsidiary's

financial statements and the parent's consolidated financial statements. Upon extinguishment of mandatorily redeemable shares that are classified as a liability, any difference between the carrying amount and the redemption amount is recognized as a gain or loss. [470-50-05-1, 15-3 – 15-4, 40-2, 40-4]

6.4.30 Conditional obligations



Excerpt from ASC 480-10

- > Mandatorily Redeemable Financial Instruments

55-3 Various financial instruments issued in the form of shares embody unconditional obligations of the issuer to redeem the instruments by transferring its assets at a specified or determinable date or dates or upon an event that is certain to occur.

55-4 This Section presents two examples of mandatorily redeemable financial instruments:

- a. Certain forms of trust-preferred securities (those that are required to be redeemed at specified or determinable dates)
- b. Stock that must be redeemed upon the death or termination of the individual who holds it, which is an event that is certain to occur.

55-5 Although some mandatorily redeemable instruments are issued in the form of shares, those instruments are classified as liabilities under this Subtopic because of the embodied obligation on the part of the issuer to transfer its assets.

- • > Reclassification of Stock that Becomes Mandatorily Redeemable

55-10 The guidance that follows discusses the requirement in paragraph 480-10-25-7 for reclassification of stock that becomes mandatorily redeemable. For example, an entity may issue equity shares on January 2, 2004, that must be redeemed (not at the option of the holder) six months after a change in control. When issued, the shares are conditionally redeemable and, therefore, do not meet the definition of mandatorily redeemable. On December 30, 2008, there is a change in control, requiring the shares to be redeemed on June 30, 2009. On December 31, 2008, the issuer would treat the shares as mandatorily redeemable and reclassify the shares as liabilities, measured initially at fair value. Additionally, the issuer would reduce equity by the amount of that initial measure, recognizing no gain or loss.

55-11 For another example of a conditionally redeemable instrument, an entity may issue preferred shares with a stated redemption date 30 years hence that also are convertible at the option of the holders into a fixed number of common shares during the first 10 years. Those instruments are not mandatorily redeemable for the first 10 years because the redemption is conditional, contingent upon the holder's not exercising its option to convert into common shares. However, when the conversion option (the condition) expires, the

shares would become mandatorily redeemable and would be reclassified as liabilities, measured initially at fair value.

55-12 If the conversion option were nonsubstantive, for example, because the conversion price is extremely high in relation to the current share price, it would be disregarded as provided in paragraph 480-10-25-1. If that were the case at inception, those preferred shares would be considered mandatorily redeemable and classified as liabilities with no subsequent reassessment of the nonsubstantive feature.

One of the basic requirements for a financial instrument to be in the scope of Topic 480 is that the instrument reflect an obligation of the issuer (see section 6.2.30). However, for such an instrument to be considered mandatorily redeemable, the obligation to redeem needs to be unconditional. [480-10-25-4]

An issuer needs to reassess a share with a conditional obligation at each reporting date to determine if it has become mandatorily redeemable. [480-10-25-5, 25-7]



Question 6.4.180

Is a share considered mandatorily redeemable if it is redeemable only upon the occurrence of a future event that is uncertain to occur?

Interpretive response: No. A share that is redeemable solely upon the occurrence of an event that is uncertain to occur and outside the control of the issuer or holder is generally not considered mandatorily redeemable. An example is when redemption is required if there is a reduction in the issuer's credit rating. However, such a share is mandatorily redeemable if the condition is nonsubstantive or minimal so as to make the obligation to redeem unconditional (see section 6.2.40) and the share meets all the applicable criteria.

Further, a share with a conditional redemption obligation that is triggered by an event that is not certain to occur can become a mandatorily redeemable instrument when: [480-10-25-5, 25-7]

- the event occurs;
- the condition is resolved; or
- the event becomes certain to occur.

If redemption is outside the issuer's control (e.g. the share is redeemable based on the occurrence of an event), the share may be subject to the guidance for temporary equity and its related interpretations if the issuer is an SEC registrant (see section 6.2.10 and chapter 7).



Question 6.4.190

When does an issuer evaluate whether any condition of a redeemable instrument is nonsubstantive or minimal?

Interpretive response: If a share conditionally obligates the issuer to redeem it, the issuer evaluates the conditional obligation as of the date of issuance. The issuer determines whether the condition is nonsubstantive or minimal as part of its analysis to determine whether the share is mandatorily redeemable at the inception of the instrument. [480-10-55-12]

An issuer is not permitted to reassess the condition at a later date, except when a conditionally redeemable instrument becomes mandatorily redeemable because the event has occurred, the condition is resolved or the event becomes certain to occur (see Question 6.2.110). [480-10-25-4 – 25-5, 25-7, 55-12]



Question 6.4.200

What does an issuer consider when assessing whether any condition of a redeemable share is nonsubstantive or minimal?

Interpretive response: To determine whether the conditions in a redeemable share are nonsubstantive or minimal, the issuer evaluates whether the conditional obligation effectively makes the share mandatorily redeemable. However, the issuer does not perform a probability analysis in its evaluation; meaning a conditional feature is not nonsubstantive or minimal just because redemption is highly probable. [480-10-55-12]

Although no single factor is determinative, we believe an issuer should consider whether:

- redemption is contractually required at a certain date;
- either party is required to exercise its 'conditional' option;
- another contract requires the issuer to redeem the share;
- the documents governing the operations of the issuer (e.g. articles of incorporation, charter) require it to redeem the share (see Example 6.2.40);
or
- the issuer has otherwise committed itself to redeem the share.



Question 6.4.210

How does an issuer account for the resolution of the contingency of an equity-classified contingently redeemable share?

Interpretive response: If an issuer had classified a contingently redeemable share as equity, and the contingent event occurs or becomes certain to occur so as to make the share mandatorily redeemable, the issuer reclassifies the

share at that date to a liability at its then fair value with an offset to equity. The issuer records no gain or loss in its income statement at the date of reclassification. [260-10-S99-2, 480-10-S99-3A]

See section 3.3.50 of KPMG Handbook, [Earnings per share](#), for additional guidance about computing EPS on settlement of equity-classified preferred shares.



Question 6.4.220

How is an instrument classified if the issuer determines it has become mandatorily redeemable before the financial statements are issued?

Interpretive response: If, subsequent to the reporting date, but before it issues its financial statements (they are available for issue), an issuer learns that a share has become mandatorily redeemable, it applies Topic 855 (subsequent events).

If the information received after the reporting date demonstrates that the share became mandatorily redeemable on or before the reporting date, the issuer reclassifies the share as a liability in its financial statements as of the date the share became mandatorily redeemable.

If the information shows that the share became mandatorily redeemable after the reporting date, the issuer does not revise its financial statement classification. However, it does make the appropriate disclosures required by Topic 855.

6.4.40 Shares with conditional obligations

This section explains how the accounting guidance on mandatorily redeemable instruments is applied to the following types of instruments:

- callable and puttable shares; and
- convertible shares.

Callable and puttable shares are typically not mandatorily redeemable. However, they could be considered mandatorily redeemable in certain instances. Although embedded features are not in the scope of Topic 480, callable and puttable shares are assessed in their entirety when determining whether the entire share is mandatorily redeemable.

In addition to determining whether these shares are in the scope of Topic 480, an issuer assesses whether a share contains an embedded derivative that requires separate accounting at the issuance date. [815-15]

See KPMG Handbook, [Derivatives and hedging](#), for guidance about accounting for embedded derivatives.

Callable and puttable shares



Question 6.4.230

Are callable shares considered mandatorily redeemable?

Interpretive response: Typically, callable shares are not mandatorily redeemable instruments. Callable shares allow the issuer to buy them back from the holder for cash. Redemption is not mandatory because the issuer may choose to exercise or not exercise the call option, but has no obligation (see Example 6.4.60).



Example 6.4.60

Callable preferred shares

On June 30, Year 1, Issuer issues preferred shares to Holder that allow Issuer to call them from Holder any time after December 31, Year 5. The option is not nonsubstantive or minimal.

Issuer analyzes the preferred shares using the diagram in Question 6.4.10.

Mandatorily redeemable criteria	Satisfied?
Freestanding	✓
Does not meet scope exception for certain mandatorily redeemable instruments (see section 6.4.20)	✓
Outstanding share	✓
Unconditionally obligates Issuer to redeem instrument	✗
Requires redemption by transferring its assets at specified or determinable date(s) or upon event that is certain to occur	✗

This analysis indicates that the preferred shares are not mandatorily redeemable. Issuer is not unconditionally obligated to redeem the preferred shares – it may choose to call the shares from the holder any time after December 31, Year 5.



Question 6.4.240

Are puttable shares mandatorily redeemable?

Interpretive response: Typically, no. Puttable shares allow the holder to sell them back to the issuer for cash. However, the holder may allow the put option

to expire unexercised. Therefore, puttable shares are typically not mandatorily redeemable instruments because the issuer is not unconditionally obligated to redeem them by transferring assets.

However, puttable shares are (or can become) mandatorily redeemable instruments (assuming they meet the applicable criteria) if:

- the put option is nonsubstantive or minimal;
- the put option was exercised and the shares are required to be redeemed;
or
- certain contingencies are resolved.

See Example 6.4.80 for an example of a puttable share that becomes mandatorily redeemable.

Puttable shares may be subject to the guidance for temporary equity and its related interpretations if the issuer is an SEC registrant (see section 6.2.10 and chapter 7).



Example 6.4.70 Puttable preferred shares (1)

On January 1, Year 1, Issuer issues preferred shares to Holder that allow Holder to put those shares back to Issuer for \$1,000 any time after December 31, Year 5. The option is not nonsubstantive or minimal.

Issuer analyzes the preferred shares using the diagram in Question 6.4.10.

Mandatorily redeemable criteria	Satisfied?
Freestanding	✓
Does not meet scope exception for certain mandatorily redeemable instruments (see section 6.4.20)	✓
Outstanding share	✓
Unconditionally obligates Issuer to redeem instrument	✗
Requires redemption by transferring its assets at specified or determinable date(s) or upon event that is certain to occur	✗

This analysis indicates that the preferred shares are not mandatorily redeemable. Issuer is not unconditionally obligated to redeem the preferred shares. Instead, it only has to redeem the preferred shares if Holder exercises its put option.



Example 6.4.80 Puttable preferred shares (2)

On January 1, Year 1, Issuer issues preferred shares to Holder that allow Holder to put them back to Issuer for cash in an amount equal to its liquidation preference (including cumulative, unpaid dividends). Issuer is required to pay within 30 days after Holder delivers an irrevocable ‘put notice’ to Issuer. The option is not nonsubstantive or minimal.

Holder delivers an irrevocable put notice to Issuer on December 15, Year 5 and Issuer redeems the preferred shares for cash on January 14, Year 6.

Initial analysis

Issuer analyzes the preferred shares at issuance using the diagram in Question 6.4.10.

Mandatorily redeemable criteria	Satisfied?
Freestanding	✓
Does not meet scope exception for certain mandatorily redeemable instruments (see section 6.4.20)	✓
Outstanding share	✓
Unconditionally obligates Issuer to redeem instrument	✗
Requires redemption by transferring its assets at specified or determinable date(s) or upon event that is certain to occur	✗

This analysis indicates that the preferred shares are not mandatorily redeemable when they are issued. Upon issuance, Issuer is not unconditionally obligated to redeem the preferred shares – it has to redeem the preferred shares only if Holder exercises its put option.

Subsequent analysis

When Holder submits the irrevocable put notice to Issuer on December 15, Year 5, the preferred shares become mandatorily redeemable because Issuer becomes obligated to redeem them. Issuer reclassifies the preferred shares as a liability at their then fair value with an offset to equity. Issuer accounts for the dividends that accumulate between December 15, Year 5 and the redemption of the preferred shares on January 14, Year 6 as interest expense.



Example 6.4.90 Contingently puttable preferred shares

On January 1, Year 1, Issuer issues preferred shares to Holder. The preferred shares will be automatically put back to Issuer for cash in an amount equal to their liquidation preference (including cumulative, unpaid dividends) six months after a change in control. This feature is not nonsubstantive or minimal.

On December 31, Year 5 there is a change in control and the preferred shares are automatically put back to Issuer on June 30, Year 6.

Initial analysis

Issuer analyzes the preferred shares at issuance using the diagram in Question 6.4.10.

Mandatorily redeemable criteria	Satisfied?
Freestanding	✓
Does not meet scope exception for certain mandatorily redeemable instruments (see section 6.4.20)	✓
Outstanding share	✓
Unconditionally obligates Issuer to redeem the instrument	✗
Requires redemption by transferring its assets at specified or determinable date(s) or upon event that is certain to occur	✗

This analysis indicates that the preferred shares are not mandatorily redeemable when they are issued. Upon issuance, Issuer is not unconditionally obligated to redeem the preferred shares – it is obligated to redeem the preferred shares only upon a change in control.

Subsequent analysis

Upon the change in control on December 31, Year 5, the preferred shares become mandatorily redeemable because Issuer becomes obligated to redeem them. Issuer reclassifies the preferred shares as a liability at their then fair value with an offset to equity. It accounts for the dividends that accumulate between December 31, Year 5 and the redemption of the preferred shares on June 30, Year 6 as interest expense.



Question 6.4.250

Is a share that is puttable by the holder and callable by the issuer considered mandatorily redeemable?

Background: A combination of a purchased call option and a written put option in an instrument is considered as a single forward contract for the purpose of applying the requirements of Topic 815 and its related guidance if they have the same: [815-10-25-7 – 25-13, 815-20-25-43]


- strike price;
- notional amount; and
- exercise date.

Under Topic 815, an embedded purchased option and an embedded written option with the same terms are viewed as one embedded forward contract if they convey the rights and obligations of a forward contract from an economic and risk perspective and cannot be separated from the instrument in which they

are embedded. It is likely that one of the parties will exercise its option thereby redeeming the underlying instrument at some point even though neither party is required to do so. [815-10-25-7 – 25-13, 815-20-25-43]

Interpretive response: Not necessarily. Despite the guidance in Topic 815, a share is generally not mandatorily redeemable only because the holder may choose to put it and the issuer may choose to call it under the same terms. Although the combination of options may economically function as a forward contract, the combination reflects a conditional obligation because redemption is not required to occur under the terms of the contract but will occur when one of the parties exercises its option.

For example, the options could expire at-the-money, unexercised and the shares may not be redeemed. However, if the optionality in the instrument has no substance and the issuer must redeem the financial instrument by transferring its assets on a specified or determinable date, or upon an event certain to occur, the issuer disregards the optionality for determining whether the instrument is mandatorily redeemable.

 **Example 6.4.100**
Callable and puttable preferred shares

On January 1, Year 1, Issuer issues preferred shares to Holder that allow Issuer to call them from Holder. The preferred shares also allow Holder to put them back to Issuer. Both options can be exercised any time after December 31, Year 5 for \$1,000. The options are not nonsubstantive or minimal.

Issuer analyzes the preferred shares using the diagram in Question 6.4.10.

Mandatorily redeemable criteria	Satisfied?
Freestanding	✓
Does not meet scope exception for certain mandatorily redeemable instruments (see section 6.4.20)	✓
Outstanding share	✓
Unconditionally obligates Issuer to redeem instrument	✗
Requires redemption by transferring its assets at specified or determinable date(s) or upon event that is certain to occur	✗

This analysis indicates that the preferred shares are not mandatorily redeemable. Neither the call option nor put option unconditionally obligates Issuer to redeem the preferred shares – Issuer may choose to call the shares from Holder and Holder may choose to put the shares to Issuer at any time after December 31, Year 5.

A combination of a put option and a call option with the same exercise date, notional amount and strike price may function as a synthetic forward contract. However, this combination of features does not render the shares mandatorily

redeemable because the options could expire unexercised. Therefore, the redemption is not unconditional.



Example 6.4.110

Callable and puttable common shares upon death, termination or retirement

Issuer issues common shares to its employees that allows them to put the shares back to Issuer upon their death, termination or retirement. Further, Issuer can call the shares upon employees’ death, termination or retirement. The option is not nonsubstantive or minimal.

Issuer analyzes the common shares using the diagram in Question 6.4.10.

Mandatorily redeemable criteria	Satisfied?
Freestanding	✓
Does not meet scope exception for certain mandatorily redeemable instruments (see section 6.4.20)	✓
Outstanding share	✓
Unconditionally obligates Issuer to redeem instrument	✗
Requires redemption by transferring its assets at specified or determinable date(s) or upon event that is certain to occur	✗

This analysis indicates that the common shares are not mandatorily redeemable. Neither the call option nor put option unconditionally obligates Issuer to redeem the common shares – Issuer may choose to call the shares from the employees and the employees may choose to put the shares to Issuer upon the occurrence of certain specified events.

We believe that a past practice by Issuer of calling shares when an employee retires, dies or is terminated does not constitute an event that is certain to occur, or give rise to an unconditional obligation under the guidance for mandatorily redeemable financial instruments (see Question 6.4.40).

Convertible shares



Question 6.4.260

Is a share that is convertible into a fixed number of another type of the issuer’s shares mandatorily redeemable?

Interpretive response: It depends. When a share that is convertible into a fixed number of another type of the issuer’s shares continues in perpetuity if the

conversion option is not exercised, the issuer is not unconditionally obligated to redeem the instrument. Therefore, the share is not mandatorily redeemable. [480-10-25-4, 25-6]

Another type of convertible share may require the issuer to redeem it for cash on a specified date if the conversion option is not exercised. During the time that conversion option is outstanding, the share is not mandatorily redeemable because the holder has the option to convert the shares during that time. If the holder converts the shares, the issuer transfers a fixed number of its shares and not its assets. However, this type of convertible share is (or becomes) a mandatorily redeemable instrument (assuming the applicable recognition criteria under Topic 480 are met) if the conversion option:

- is nonsubstantive or minimal; or
- expires unexercised because the shares are mandatorily redeemable at that point.



Example 6.4.120

Convertible redeemable preferred shares

On June 30, Year 1, Issuer issues convertible preferred shares to Holder. Holder can convert the preferred shares into a fixed number of Issuer common shares on or before June 30, Year 6. Issuer must redeem the preferred shares for an amount equal to its liquidation preference (including cumulative, unpaid dividends) on June 30, Year 8. The conversion option is not nonsubstantive or minimal.

Initial analysis

Issuer analyzes the preferred shares at issuance using the diagram in Question 6.4.10.

Mandatorily redeemable criteria	Satisfied?
Freestanding	✓
Does not meet scope exception for certain mandatorily redeemable instruments (see section 6.4.20)	✓
Outstanding share	✓
Unconditionally obligates Issuer to redeem instrument	✗
Requires redemption by transferring its assets at specified or determinable date(s) or upon event that is certain to occur	✗

This analysis indicates that the convertible preferred shares are not mandatorily redeemable when they are issued. Issuer is not unconditionally obligated to redeem the preferred shares because Holder may convert the preferred shares into common shares before the redemption date. In this example, Issuer transfers a fixed number of its shares and not its assets. Issuer has to redeem

the preferred shares at the redemption date only if Holder did not previously convert the preferred shares.

Subsequent analysis

If the conversion option expires unexercised, the preferred shares become mandatorily redeemable. This is when Issuer becomes unconditionally obligated to redeem them. Issuer reclassifies the preferred shares as a liability at their then fair value with an offset to equity.

Conversion contingent on the common shares reaching a certain price

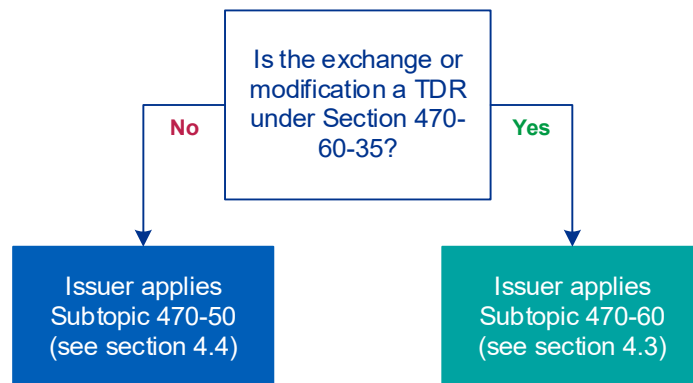
If Holder can convert the preferred shares only upon the common shares reaching a certain price, the preferred shares would not be mandatorily redeemable at issuance because they:

- do not unconditionally obligate Issuer to redeem them by transferring assets – Holder may convert before the redemption date and Issuer transfers a fixed number of its shares and not its assets; and
- do not contain a specific date on which assets must be transferred – they contain a date on which Issuer may be required to pay cash if, and only if, Holder has not previously converted the preferred shares into a fixed number of its common shares.

However, similar to the preferred shares that are convertible at any time, if the conversion option expires unexercised, the preferred shares become mandatorily redeemable.

6.4.50 Modifications, exchanges and extinguishments of mandatorily redeemable instruments

A holder and an issuer may exchange or modify debt instruments for various reasons. Mandatorily redeemable financial instruments under Topic 480 are subject to the accounting guidance applicable to other debt instruments in the event of modification, exchange or extinguishment, as follows.



Mandatorily redeemable instruments issued by subsidiaries are also subject to this guidance if those instruments are classified as liabilities under Topic 480. Subtopic 470-50 requires that a parent recognize a gain or loss upon

extinguishment of the subsidiary's liability for mandatorily redeemable preferred shares for any difference between their redemption amount and carrying amount. [810-10-40-2A]

If an instrument is a mandatorily redeemable instrument, but is outside the scope of Topic 480, an issuer applies other accounting principles. For example, if a mandatorily redeemable instrument issued by a nonpublic subsidiary is outside the scope of Topic 480 because of the liquidation exception, in the parent's consolidated financial statements the extinguishment of the instrument is accounted for as a capital transaction. [810-10-40-2]

6.4.60 Mandatorily redeemable preferred shares of a subsidiary



Excerpt from ASC 810-10

> Redemption of Subsidiary's Redeemable Stock

40-1 Accounting for the purchase (early extinguishment) of a wholly owned **subsidiary's** mandatorily redeemable preferred stock, including stock that contains a redemption feature but is not considered a mandatorily redeemable financial instrument under Topic 480, differs dependent on whether the preferred stock is required under Topic 480 to be accounted for as a liability.

- > Mandatorily Redeemable Preferred Stock Not Accounted for as a Liability

40-2 Section 480-10-25 does not require mandatorily redeemable preferred stock to be accounted for as a liability under certain conditions. If such conditions apply and the mandatorily redeemable preferred stock is not accounted for as a liability, then the entity's acquisition of a subsidiary's mandatorily redeemable preferred stock shall be accounted for as a capital stock transaction. Accordingly, the consolidated entity would not recognize in its income statement any gain or loss from the acquisition of the subsidiary's preferred stock. In the **consolidated financial statements**, the dividends on a subsidiary's preferred stock, whether mandatorily redeemable or not, would be included in noncontrolling interest as a charge against income.

- > Mandatorily Redeemable Preferred Stock Accounted for as a Liability

40-2A Section 480-10-25 requires mandatorily redeemable preferred stock to be accounted for as a liability under certain conditions. If mandatorily redeemable preferred stock is accounted for as a liability, then any amounts paid or to be paid to holders of those contracts in excess of the initial measurement amount are reflected as interest cost and not as **noncontrolling interest** charge. Topic 860 specifies whether a liability has been extinguished and Subtopic 470-50 requires that the **parent** recognize a gain or loss upon extinguishment of the subsidiary's liability for mandatorily redeemable preferred shares for any difference between the carrying amount and the redemption amount.

Subtopic 810-10 provides guidance about how a parent accounts for the purchase (extinguishment) of a wholly owned subsidiary's mandatorily redeemable preferred shares. The accounting differs depending on whether the instruments are classified as liabilities under Topic 480 or meet one of the scope exceptions under Topic 480 and are not accounted for as a liability (see section 6.4.20).

See section 7.5 of KPMG Handbook, [Consolidation](#), for additional discussion about NCI.

6.4.70 Disclosures



Excerpt from ASC 480-10

50-1 Entities that issue **financial instruments** recognized under the guidance in Section 480-10-25 shall disclose both of the following:

- a. The nature and terms of the financial instruments
- b. The rights and obligations embodied in those instruments, including both:
 1. Settlement alternatives, if any, in the contract
 2. The entity that controls the settlement alternatives.

50-2 Additionally, for all outstanding financial instruments recognized under the guidance in Section 480-10-25 and for each settlement alternative, issuers shall disclose all of the following:

- a. The amount that would be paid, or the number of **shares** that would be issued and their **fair value**, determined under the conditions specified in the contract if the settlement were to occur at the reporting date
- b. How changes in the fair value of the **issuer's equity shares** would affect those settlement amounts (for example, "the **issuer** is obligated to issue an additional X shares or pay an additional Y dollars in cash for each \$1 decrease in the fair value of one share")
- c. The maximum amount that the issuer could be required to pay to redeem the instrument by **physical settlement**, if applicable
- d. The maximum number of shares that could be required to be issued, if applicable
- e. That a contract does not limit the amount that the issuer could be required to pay or the number of shares that the issuer could be required to issue, if applicable
- f. For a forward contract or an option indexed to the issuer's equity shares, all of the following:
 1. The forward price or option strike price
 2. The number of issuer's shares to which the contract is indexed
 3. The settlement date or dates of the contract, as applicable.

50-3 Paragraph 505-10-50-3 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.

50-4 Some entities have no equity instruments outstanding but have financial instruments in the form of shares, all of which are **mandatorily redeemable**

financial instruments required to be classified as liabilities. Those entities shall disclose the components of the liability that would otherwise be related to shareholders' interest and other comprehensive income (if any) subject to the redemption feature (for example, par value and other paid-in amounts of mandatorily redeemable instruments shall be disclosed separately from the amount of retained earnings or accumulated deficit).

Topic 505 contains disclosure requirements that are intended to provide financial statements users with information useful when analyzing an entity's liabilities and equity. The disclosure requirements of paragraphs 480-10-50-1 to 50-4 (listed in the above excerpt) are incremental to those in Topic 505 and other authoritative guidance. The additional information required by Topic 480 is intended to help financial statement users evaluate an entity's economic exposure to financial instruments that could be settled in an entity's shares. Section 5.12 discusses the disclosure requirements of Topic 505. [505-10-15-1, 50-3 – 50-5, 50-11]



Question 6.4.270

What incremental disclosures does an entity make if all issued financial instruments are mandatorily redeemable?

Interpretive response: If all of an issuer's financial instruments are mandatorily redeemable, the issuer discloses the components of the liability that would otherwise be related to shareholders' interest and OCI (if any) subject to the redemption feature. For example, an issuer discloses the par value and other paid-in amounts of mandatorily redeemable instruments separately from the amount of retained earnings. [480-10-50-4]

The issuer also discloses the nature and composition of its mandatorily redeemable instruments. For example, the issuer discloses: [480-10-50-1 – 50-4]

- the event(s) triggering redemption;
- the number of shares issued and outstanding;
- the par value associated with those financial instruments; and
- any retained earnings or AOCI that would be distributed on redemption.

6.4.80 Presentation considerations



Excerpt from ASC 480-10

> Presentation

45-2 Entities that have no equity instruments outstanding but have **financial instruments** issued in the form of shares, all of which are **mandatorily redeemable financial instruments** required to be classified as liabilities, shall describe those instruments as shares subject to mandatory redemption in

statements of financial position to distinguish those instruments from other liabilities. Similarly, payments to holders of such instruments and related accruals shall be presented separately from payments to and interest due to other creditors in statements of cash flows and income.

45-2A Some entities have outstanding shares, all of which are subject to mandatory redemption on the occurrence of events that are certain to occur. The redemption price may be a fixed amount or may vary based on specified conditions. If all of an entity's shares are subject to mandatory redemption and the entity is not subject to the deferral in paragraphs 480-10-15-7A through 15-7F, an excess of the redemption price of the shares over the entity's equity balance shall be reported as an excess of liabilities over assets (a deficit), even though the mandatorily redeemable shares are reported as a liability. If the redemption price of the mandatorily redeemable shares is less than the book value of those shares, the entity should report the excess of that book value over the liability reported for the mandatorily redeemable shares as an excess of assets over liabilities (equity).

45-2B Depending on the settlement terms, this Subtopic requires that mandatorily redeemable shares that are not subject to the deferral in paragraphs 480-10-15-7A through 15-7F be measured at either the present value of the amount to be paid at settlement or the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount as interest cost (change in redemption amount).

- > Example 1: Mandatorily Redeemable Financial Instruments—Stock to Be Redeemed upon Death of the Holder

55-64 This Example illustrates the application of the guidance in this Subtopic to stock to be redeemed upon the death of the holder. An entity may issue shares of stock that are required to be redeemed upon the death of the holder for a proportionate share of the book value of the entity. The death of the holder is an event that is certain to occur. Therefore, the stock is classified as a liability. (An insurance contract that would cover the cost of the redemption does not affect the classification of the stock as a liability.) If the stock represents the only shares in the entity, the entity reports those instruments in the liabilities section of its statement of financial position and describes them as shares subject to mandatory redemption so as to distinguish the instruments from other financial statement liabilities. The issuer presents interest cost and payments to holders of such instruments separately, apart from interest and payments to other creditors, in statements of income and cash flows. The entity also discloses that the instruments are mandatorily redeemable upon the death of the holders. The following presentation is an example of the required presentation and disclosure for entities that have no equity instruments outstanding but have shares, all of which are mandatorily redeemable financial instruments classified as liabilities.

Statement of Financial Position:

Total assets	<u>\$ 1,800,000</u>
Liabilities other than shares	\$ 1,000,000
Shares subject to mandatory redemption ^(a)	<u>800,000</u>
Total liabilities	<u>\$ 1,800,000</u>

Notes to Financial Statements:

(a) Shares, all subject to mandatory redemption upon death of the holders, consist of:

Common stock—\$100 per value, 10,000 shares authorized, 5,000 shares issued and outstanding	\$ 500,000
Retained earnings attributable to those shares	320,000
Accumulated other comprehensive income attributable to those shares	(20,000)
	\$ 800,000

An issuer may determine that all of the financial instruments it has issued are mandatorily redeemable – e.g. if the issuer is required to redeem them on the holder’s death. In that case, and assuming that a scope exception does not apply, the issuer describes those instruments as ‘shares subject to mandatory redemption’ to distinguish them from other liabilities. Similarly, payments to holders and related expenses are presented on a separate line from payments to and interest due to other creditors in the statement of cash flows and the income statement. [\[480-10-45-2\]](#)



Question 6.4.280

Does an SEC registrant follow special presentation requirements if all of its outstanding shares are mandatorily redeemable?

Interpretive response: Yes. An SEC registrant that has no equity instruments outstanding, but that has issued mandatorily redeemable instruments, describes those instruments as shares subject to mandatory redemption in the liability section of its balance sheet. It does this to distinguish those instruments from other liabilities. Similarly, payments to holders and related expenses are presented on a separate line from payments to and interest due to other creditors in the statement of cash flows and income statement. [\[480-10-45-2\]](#)

Further, the issuer discloses the components of the liability that would otherwise be related to shareholders’ interests and OCI (if any) subject to the redemption feature. For example, par value and other paid-in amounts of mandatorily redeemable instruments are required to be disclosed separately from the amount of retained earnings. [\[480-10-55-64\]](#)



Example 6.4.130

Presentation and disclosures if all shares are mandatorily redeemable

Issuer meets the definition of a ‘nonpublic entity’ under Topic 480 because it:

- does not have equity securities traded in a public market or in the over-the-counter market;
- has not made a filing with a regulatory agency in preparation for the sale of equity securities in a public market; and
- is not controlled by an entity covered by either of the above two points.

However, Issuer meets the definition of an ‘SEC registrant’ because its debt securities are traded on a public market and it is required to file financial statements with the SEC.

Issuer has issued one class of common shares, which its employees hold. It is required to redeem the common shares at their fair value for cash upon a holder’s death or termination of employment.

Issuer’s common shares are mandatorily redeemable because they:

- are issued in the form of shares;
- unconditionally obligate Issuer to redeem the common shares by transferring assets (cash); and
- contain an event certain to occur upon which Issuer’s assets are required to be transferred (death or termination of the employee).
- are issued by an SEC registrant.

Because Issuer meets the definition of a nonpublic entity but is an SEC registrant, the scope exception in Topic 480 for certain mandatorily redeemable instruments of nonpublic entities does not apply. Therefore, these mandatorily redeemable instruments (with uncertain redemption amounts and dates) are in the scope of Topic 480.

Because the mandatorily redeemable instruments represent Issuer’s only shares, Issuer presents them as ‘shares subject to mandatory redemption’ in the liabilities section of its balance sheet.

Total assets	\$100
Liabilities other than shares	\$ 60
Shares subject to mandatory redemption	40
Total liabilities	\$100

The following is an example of the related disclosures for those instruments.

Notes to financial statements

Shares, all of which are subject to mandatory redemption upon the holders’ death or termination of employment, comprise:	
Common stock – \$0.01 par value, 1,000 shares authorized, 100 shares issued and outstanding	\$ 1
APIC	24
Retained earnings attributable to those shares	10
AOCI attributable to those shares	5
Total	\$ 40

6.5 Obligations to repurchase the issuer's equity shares by transferring assets



Excerpt from ASC 480-10

> Obligations to Repurchase Issuer's Equity Shares by Transferring Assets

25-8 An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:

- a. It embodies an **obligation** to repurchase the **issuer's equity shares**, or is indexed to such an obligation.
- b. It requires or may require the **issuer** to settle the obligation by transferring assets.

25-9 In this Subtopic, indexed to is used interchangeably with based on variations in the **fair value** of. The phrase requires or may require encompasses instruments that either conditionally or unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the **transfer** of assets is irrelevant.

25-10 Examples of financial instruments that meet the criteria in paragraph 480-10-25-8 include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

25-11 All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.

25-12 Certain financial instruments that embody obligations that are liabilities within the scope of this Subtopic also may contain characteristics of assets but be reported as single items. Some examples include the following:

- a. Net-cash-settled or net-share-settled forward purchase contracts
- b. Certain combined options to repurchase the issuer's **shares**.

Those instruments are classified as assets or liabilities initially or subsequently depending on the instrument's fair value on the reporting date.

25-13 An instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets, accordingly:

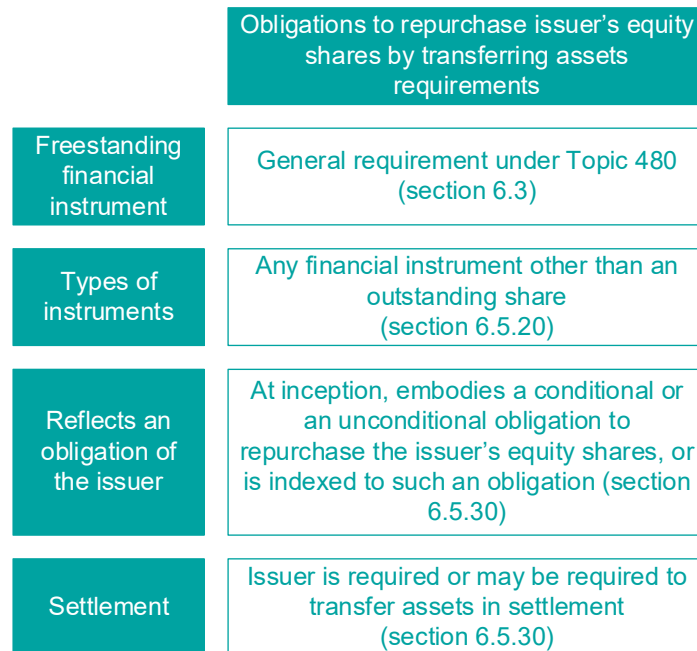
- a. When applying paragraphs 480-10-25-8 through 25-12, this also would apply for an instrument settled with another instrument that ultimately may require settlement by a transfer of assets (warrants for puttable shares).
- b. It is clear that a warrant for mandatorily redeemable shares would be a liability under this Subtopic.

6.5.10 Overview

The second class of instruments that require liability classification under Topic 480 is instruments that represent an obligation to repurchase the issuer’s equity shares by transferring assets; see overview in section 6.1. [480-10-25-8]

Question 6.5.10
How does an issuer determine whether an instrument is an obligation to repurchase its equity shares by transferring assets?

Interpretive response: The following diagram summarizes the criteria for determining whether an instrument reflects an obligation to repurchase its equity shares by transferring assets. If it does not meet the criteria, it may still be in the scope of another class of financial instrument under Topic 480 (see Questions 6.4.10 and 6.6.10). If the instrument is not in the scope of Topic 480, an entity considers other US GAAP, including the requirements related to temporary equity (see chapter 7) and on contracts in an entity’s own equity (see chapter 8).



The diagram incorporates the two general scope requirements outlined in section 6.2.10 – the financial instrument must be freestanding and reflect an obligation of the issuer. Further, an instrument must also meet the remaining requirements in the diagram to be accounted for as an obligation to repurchase the issuer’s equity shares by transferring assets. [480-10-25-8]

These contracts include forward purchase contracts and written put options on the issuer’s shares that the issuer will physically (gross) settle or net-cash

settle. Examples 6.5.20 through 6.5.50 illustrate how Topic 480 applies to basic forward contracts and options. [\[480-10-15-3\]](#)



Question 6.5.20

Can a put option embedded in equity shares be an obligation to repurchase shares by transferring assets?

Interpretive response: No. As discussed in section 6.2.20, a financial instrument must be freestanding to be in the scope of Topic 480 so an embedded option is not in the scope of Topic 480. In contrast, a freestanding put option on the entity's equity shares could be in the scope of Topic 480. [\[480-10-10-1, 15-5\]](#)



Example 6.5.10

Embedded put rights

Issuer issues common shares on July 1, Year 1, which are puttable for cash by the holder any time after July 1, Year 5, under put rights embedded in the equity shares. The put option is not nonsubstantial or minimal.

Because the put options are embedded in outstanding equity shares, they are not in the scope of Topic 480. They are outside the scope even though at inception they:

- embody an obligation for Issuer to repurchase its equity shares; in this example, it is conditioned on Holder exercising the put options; and
- may require Issuer to settle the obligation by transferring cash.

If the put options were freestanding, they would be accounted for as an obligation to repurchase equity by transferring assets because they meet the criteria described in the diagram in Question 6.5.10.

The common shares are also not mandatorily redeemable under Topic 480 because although they are issued in the form of shares, they do not:

- embody an unconditional obligation for Issuer to redeem the instrument by transferring assets. They are exercisable at Holder's discretion and therefore conditional; or
- contain a specific date on which Issuer is required to transfer its assets to Holder. It only indicates the date after which Holder may put the common shares to Issuer.

6.5.20 Not an outstanding share

The first characteristic of a freestanding financial instrument in the scope of the guidance for obligations to repurchase an entity's own equity shares by

transferring assets is that it is not an outstanding share (see diagram in Question 6.5.10). [480-10-25-8]

Question 6.2.50 lists the various legal forms of ownership that are also shares and therefore outside the scope of this guidance. However, the instrument may be in the scope of the guidance on mandatorily redeemable financial instruments (see section 6.4) or certain obligations to settle by issuing a variable number of shares (see section 6.6). [480-10-25-8]

6.5.30 Issuer obligated to repurchase its own shares by transferring assets

This section discusses the remaining criteria for a financial instrument to be considered an obligation to repurchase an entity's own equity shares by transferring assets (see diagram in Question 6.5.10):

- the instrument must require the issuer to repurchase its own shares or be indexed to such an obligation (second criterion); and
- the instrument must require the issuer to settle by transferring assets (third criterion).



Question 6.5.30

Can the issuer's obligation to repurchase its equity shares be conditional?

Interpretive response: Yes. Under Topic 480, the issuer's obligation to repurchase its own equity shares may be a conditional or an unconditional obligation (see section 6.2.30 and Example 6.2.10). Two examples provided by Topic 480 are forward purchase contracts and written put options on the issuer's equity shares that the issuer must physically settle or net-cash settle. [480-10-15-3]

The following discussion is based on a forward purchase contract, but other types of contracts to repurchase an issuer's equity shares may also reflect conditional obligations for the issuer to transfer cash.

A forward purchase contract is one type of a financial instrument that can contain an unconditional or conditional obligation to repurchase an issuer's equity shares by transferring assets. Such a contract meets the first criterion because it is not an outstanding share of the issuer (see section 6.5.20).

- **Unconditional obligation.** If the contract must be physically settled by delivering cash for a fixed number of the issuer's equity shares, it creates an unconditional obligation for the issuer to transfer cash to pay the full repurchase price of the equity shares.

This is like a treasury share purchase using borrowed funds – the contract effectively converts the shares that the counterparty must deliver into mandatorily redeemable instruments, which are classified as liabilities under Topic 480. Therefore, if an issuer must physically settle a forward contract by delivering cash for a fixed number of its equity shares, the

issuer classifies the contract as a liability under the guidance for obligations to repurchase its own equity shares by transferring assets. Section 6.4 discusses mandatorily redeemable shares.

- **Conditional obligation.** In contrast, a forward purchase contract that an issuer must or can net-cash settle reflects an obligation that is indexed to the repurchase of an issuer's equity shares. These contracts require the issuer to transfer assets only if the fair value of the forward purchase contract at the settlement date places the issuer in a loss position. However, if the fair value of the forward purchase contract at the settlement date places the issuer in a gain position, the issuer will receive assets. The manner of settlement with the counterparty depends on whether the fair value of the forward purchase contract is in a loss or gain position.



Question 6.5.35

Does an issuer consider whether shares underlying a written call option would meet the requirements for temporary equity classification?

Background: As explained in section 7.3, an equity share is classified as temporary equity if it contains a feature that requires the issuer to deliver cash or assets to redeem the share, under circumstances that are outside the issuer's control. For example, temporary equity classification is required for equity shares with:

- certain deemed liquidation clauses (see Question 7.3.230); or
- share settlement features for which cash settlement is presumed because the issuer cannot demonstrate that it can settle in shares under all circumstances (see Question 7.3.140).

Interpretive response: Yes, when evaluating whether a written call option (e.g. a warrant on redeemable preferred or redeemable common shares) is an obligation to repurchase equity shares by transferring assets, an issuer considers whether shares underlying the option would meet the requirements for temporary equity classification when issued. Temporary equity-classified shares are redeemable outside the issuer's control and may require the entity to transfer assets or cash in settlement. A written call option on such a share is similar to an instrument whose obligation is settled with another instrument that the issuer must ultimately settle for cash or other assets – e.g. a warrant for a puttable share or for a share that is mandatorily redeemable. Such an instrument is an obligation to repurchase equity shares by transferring assets. [\[480-10-25-13\]](#)

Therefore, we believe a written call option (e.g. a warrant) on such a share should be classified as a liability because it: [\[480-10-25-8, 25-9, 25-13\]](#)

- is a financial instrument other than an outstanding share; and
- embodies an obligation (whether conditional or unconditional) to repurchase the issuer's own shares that may require the issuer to ultimately transfer assets.

Said differently, the call option is liability-classified because the option’s holder may exercise it and subsequently put the shares received back to the issuer for cash or other assets.

The guidance in this Question applies even when an entity does not otherwise apply the SEC’s temporary equity guidance to the shares underlying the call option. As discussed in section 7.2.20, only certain issuers are required – and certain other issuers may elect – to apply that guidance. However, Topic 480’s guidance that requires an issuer to liability-classify an obligation to repurchase equity shares by transferring assets applies to all entities. As a result, we believe that if the requirements for temporary equity classification would be met for a share underlying the call option, liability classification is required for the call option – even if the entity does not apply the SEC’s temporary equity guidance.


Question 6.5.37

Does a contract that requires a transfer of assets upon liquidation represent an obligation to repurchase the issuer’s equity shares by transferring assets?

Interpretive response: We believe it depends on whether the event triggering the transfer of assets is an ordinary or deemed liquidation, as explained in the table below. Our view is based on analogy to the scope exceptions from the temporary equity classification requirements for liquidation events.

Event requiring transfer of assets:	Is the contract excluded from the scope of obligations to repurchase the issuer’s equity shares by transferring assets?
‘Ordinary’ liquidation of the entity	<p>Yes. We believe such a contract is excluded from the scope. In addition to being consistent with the scope exception from the temporary equity classification requirements (see Question 7.3.50), this is also consistent with: [480-10-25-4, S99-3A(3)(f), 815-40-25-9]</p> <ul style="list-style-type: none"> — the ‘only upon liquidation’ exception for mandatorily redeemable financial instruments (see Question 6.4.140); and — the circumstance in which net-cash settlement does not cause an instrument to fail the requirements of the equity classification guidance (see section 8.11).
‘Deemed liquidation event’	<p>It depends. A deemed liquidation clause does not result in a contract being excluded from the scope unless the events that could trigger the clause are solely in the issuer’s control (see Question 6.2.85). [480-10-S99-3(3)(f)]</p> <p>However, we believe there is a narrow and limited exception for clauses characterized as deemed liquidation provisions but triggered by something other than the ordinary liquidation of the issuer. Under this exception, a deemed liquidation clause</p>

Event requiring transfer of assets:	Is the contract excluded from the scope of obligations to repurchase the issuer's equity shares by transferring assets?
	is excluded from the scope if all holders of equally and more subordinated equity instruments would: [480-10-S99-3(3)(f)] <ul style="list-style-type: none"> — also be entitled to redeem; and — on redemption, receive the same form of consideration. See section 7.3.40 for further information about this limited exception.

 **Question 6.5.40**
What does it mean to be 'indexed to such an obligation'?

Interpretive response: Under Topic 480, a financial instrument may be classified as a liability if it embodies an obligation or is indexed to an obligation to repurchase the issuer's equity shares. When the net-cash payment or receipt on an instrument is based on the issuer's requirement to buy its own shares, the instrument is considered indexed to such an obligation. [480-10-25-8]

'Indexed to' in this context is used interchangeably with 'based on variations in the fair value of' an obligation to repurchase the issuer's equity shares. Therefore, when determining whether an instrument is indexed to the repurchase of an issuer's equity shares, the issuer evaluates whether the instrument is based on variations in the fair value of an obligation to repurchase its equity shares. [480-10-25-9]

Examples of instruments that may be indexed to the repurchase of an issuer's equity shares include a puttable warrant (see Example 6.10.50), or a forward purchase contract that is net-cash settled (see Example 6.5.20), or a written put option that is net-cash settled (see Example 6.5.40). [480-10-55-19]

 **Example 6.5.15**
Contingently puttable warrants

On January 1, Year 1, Issuer issues a warrant whereby Holder can elect to purchase a fixed number of Issuer's common shares for \$50 per share at any time for a period of five years. However, in the event of a fundamental transaction, Holder has the option to put the warrant back to the entity for its fair value. The consideration Holder will receive upon exercising the put depends on whether:

- **the fundamental transaction is in Issuer's control** (e.g. merger, sale of significant assets): Holder will receive cash consideration; or
- **the fundamental transaction is not in Issuer's control** (e.g. tender offer): Holder will receive consideration in the form that is being offered and paid to holders of common stock in connection with the fundamental change.

The only equity instruments Issuer has outstanding are the warrants and the class of common stock underlying the warrants.

The warrant's put feature is not indexed to an obligation to repurchase Issuer's shares. A warrant that is puttable for its fair value is more economically similar to (i.e. indexed to) a written call option that is net-cash settled (see Example 6.5.50) than to an obligation to repurchase an entity's shares.

In addition, the warrant would not represent an obligation to repurchase the Issuer's own shares because Issuer will only be required to transfer assets to Holder upon the occurrence of events that are in Issuer's control (see Question 6.2.85) or when Holder receives the same form of consideration that the holders of shares underlying the warrant are entitled to receive (see Question 6.5.35).

Basic forward contracts and options



Excerpts from ASC 480-10

• • > Combination of Written Put Option and Purchased Call Option Issued as a Freestanding Instrument

55-18 If a **freestanding financial instrument** consists solely of a written put option to repurchase the issuer's equity shares and another option, that freestanding financial instrument in its entirety is subjected to paragraphs 480-10-25-4 through 25-14 to determine if it meets the requirements to be classified as a liability.

55-19 For example, an entity may enter into a contract that requires it to purchase 100 shares of its own stock on a specified date for \$20 if the stock price falls below \$20 and entitles the entity to purchase 100 shares on that date for \$21 if the stock price is greater than \$21. That contract shall be analyzed as the combination of a written put option and a purchased call option and not as a forward contract. The written put option on 100 shares has a strike price of \$20, and the purchased call option on 100 shares has a strike price of \$21. If at issuance the fair value of the written put option exceeds the fair value of the purchased call option, the issuer receives cash and the contract is a net written option—a liability. If required to be physically settled, that contract is a liability under the provisions in paragraphs 480-10-25-8 through 25-12 because it embodies an obligation that may require repurchase of the issuer's equity shares and settlement by a transfer of assets. If the issuer must or can net cash settle the contract, the contract is a liability under the provisions of those paragraphs because it embodies an obligation that is indexed to an obligation to repurchase the issuer's equity shares and may require settlement by a transfer of assets. If the issuer must or can net share settle the contract, that contract is a liability under the provisions in paragraph 480-10-25-14(c), because the monetary value of the obligation varies inversely in relation to changes in the fair value of the issuer's equity shares.

55-20 If, in this example, the fair value of the purchased call option at issuance exceeds the fair value of the written put option, the issuer pays out cash and the contract is a net purchased option, to be initially classified as an asset

under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c). If the fair values of the two options are equal and opposite at issuance, the financial instrument has an initial fair value of zero, and is commonly called a zero-cost collar. Thereafter, if the fair value of the instrument changes, the instrument is classified as an asset or a liability and measured subsequently at fair value.

The following examples illustrate a few common types of forward contracts and options and analyze whether they are obligations for an entity to repurchase its own equity shares by transferring assets.



Example 6.5.20 Forward purchase contract

Physically settled

On March 1, Year 1, Issuer enters into a forward contract to purchase its own equity shares on March 1, Year 2. The contract requires Issuer to pay \$1,000 cash to Holder in exchange for 50 of its equity shares.

The forward contract reflects an obligation to repurchase equity by transferring assets because it:

- is not an outstanding share of Issuer;
- requires Issuer to repurchase its own equity shares – in this example, an unconditional obligation; and
- requires Issuer to settle the obligation by transferring its assets (\$1,000 cash).

Net-cash settled

On March 1, Year 1, Issuer enters into a forward contract with Holder to purchase 50 of its own equity shares on March 1, Year 2, based on the following terms at that date.

Equity share price is:	Then Issuer:
> \$20	Receives cash = $50 \times (\text{share price} - \$20)$
< \$20	Pays cash = $50 \times (\$20 - \text{share price})$

The forward contract is an obligation to repurchase equity by transferring assets because it:

- is not an outstanding share of Issuer;
- is, at inception, indexed to an obligation that requires Issuer to repurchase its own equity shares – in this example, a conditional obligation; and
- may require Issuer to settle the obligation by transferring its assets; if Issuer's equity share price is less than \$20, it is required to transfer cash.

Even though Issuer may not be required to settle the forward contract by transferring its assets (Issuer receives cash if its equity share price is greater than \$20), the instrument is in the scope of the guidance for obligations to repurchase equity by transferring assets. This is because, at inception, the contract may require Issuer to settle by transferring its assets.



Example 6.5.30 Forward sale contract

Physically settled

On March 1, Year 1, Issuer enters into a forward contract to sell its own equity shares to Holder on March 1, Year 2. The contract requires Issuer to deliver 50 of its equity shares to Holder in exchange for \$1,000 cash.

The forward contract does not obligate Issuer to repurchase its equity by transferring assets. This is because, although the instrument is not an outstanding share of Issuer, it:

- does not require Issuer to repurchase its own equity shares – it represents an unconditional obligation for Issuer to sell its own equity shares; and
- does not require Issuer to settle the obligation by transferring its assets. Instead, Issuer will settle the obligation by transferring a fixed number of its equity shares and receiving \$1,000 cash.

Net-cash settled

On March 1, Year 1, Issuer enters into a forward contract to sell 50 of its own equity shares on March 1, Year 2, based on the following terms at that date.

Equity share price is:	Then Issuer:
< \$20	Receives cash = $50 \times (\$20 - \text{share price})$
> \$20	Pays cash = $50 \times (\text{share price} - \$20)$

The forward contract is not an obligation to repurchase equity by transferring assets because although it meets two criteria:

- it is not an outstanding share of Issuer; and
- it may require Issuer to settle the obligation by transferring its assets; if Issuer's share price is greater than \$20, Issuer must transfer cash.

It does not meet the third criterion because it does not require (nor is it indexed to an obligation for) Issuer to repurchase its own shares. It represents a conditional obligation for Issuer to *sell* its own equity shares.



Example 6.5.40 Written put option

Physically settled

On March 1, Year 1, Issuer writes an option contract that allows Holder, at its option, to sell (put) 50 of Issuer's equity shares to Issuer in exchange for \$1,000 cash at any time during the next year.

The written put is an obligation to repurchase equity by transferring assets because it:

- is not an outstanding share of Issuer;
- requires Issuer, at inception, to repurchase its own equity shares if the holder exercises the option – in this example, a conditional obligation; and
- requires Issuer to settle the obligation by transferring its assets – \$1,000 cash.

Net-cash settled

On March 1, Year 1, Issuer writes an option contract that allows Holder, at its option, to sell (put) 50 of Issuer’s equity shares to Issuer at a strike price of \$20 per share at any time during the next year. The settlement amount on the exercise date will be:

Equity share price on the exercise date is:	Then Issuer:
< \$20	Pays cash = 50 × (\$20 – share price)

If the equity share price is greater than \$20 on the exercise date, Holder would not exercise the put option.

The written put is an obligation to repurchase equity by transferring assets because it:

- is not an outstanding share of Issuer;
- is, at inception, indexed to an obligation that requires Issuer to repurchase its own equity shares if Holder exercises the option – here it represents a conditional obligation; and
- may require Issuer to settle the obligation by transferring its assets – if Issuer’s equity share price is less than \$20, it is required to transfer cash.



Example 6.5.50 Written call option

Physically settled

On March 1, Year 1, Issuer writes an option contract, which allows Holder, at its option, to purchase (call) 50 of Issuer’s equity shares from Issuer in exchange for \$1,000 cash at any time during the next year.

The written call is not an obligation to repurchase equity by transferring assets because although the instrument is not an outstanding share of the issuer, it:

- does not require Issuer to repurchase its own equity shares if Holder exercises the option. It represents a conditional obligation for Issuer to sell its own shares; and
- does not require Issuer to settle the obligation by transferring its assets. Issuer will settle the obligation by transferring a fixed number of its shares and receiving \$1,000 cash.

Net-cash settled

On March 1, Year 1, Issuer writes an option contract that allows Holder, at its option, to buy (call) 50 of Issuer’s equity shares from Issuer at a strike price of

\$20 per share at any time during the next year. The contract includes the following settlement terms if Holder exercises its option.

Equity share price on exercise date:	Then Issuer:
> \$20	Pays cash = $50 \times (\text{share price} - \$20)$

If the equity share price is less than \$20 on the exercise date, Holder would not exercise the call option.

The written call meets two of the criteria for an obligation to repurchase equity by transferring assets:

- it is not an outstanding share of Issuer; and
- it will require Issuer to settle the obligation by transferring its assets if the holder exercises the option; if Issuer's share price is greater than \$20, it is required to transfer cash.

However, it does not meet the third criterion because the instrument does not require Issuer (nor is indexed to an obligation) to repurchase its own equity shares. It represents a conditional obligation for Issuer to *sell* its own equity shares.

Question 6.5.50
Can an obligation to repurchase its own equity shares be classified as an asset by the issuer?

Excerpt from ASC 480-10

• > Application of this Subtopic to Specific Instruments

55-63 The following table addresses classification of freestanding written put options and forward purchase contracts within the scope of this Subtopic.

One Settlement Method			Entity Choice			Counterparty Choice		
Physical ^(a)	Net Share	Net Cash	Net Share or Physical ^(a)	Net Share or Net Cash	Net Cash or Physical ^(a)	Net Share or Physical ^(a)	Net Share or Net Cash	Net Cash or Physical ^(a)

Initial and Subsequent Classification and Measurement:

Equity									
Asset/Liability	x ^(b)	x ^(c)	x ^(c)	x ^(c)	x ^(c)	x ^(c)	x ^(c)	x ^(c)	x ^(c)

- (a) Physical settlement of the contract requires that the entity deliver cash to the holder in exchange for the shares.
- (b) Initial measurement of certain forward purchase contracts is at the present value of the redemption amount, adjusted for any consideration or unstated rights or privileges, with equity reduced by the fair value of the shares. Subsequent measurement of those forward purchase contracts is at the present value of the share redemption amount with accretion and any amounts paid or to be paid to holders (including dividends) reflected as interest cost. Measurement of a written put option, or of a forward purchase contract that is not for a fixed number of shares in exchange for cash, is at fair value with subsequent changes in fair value recorded in earnings.
- (c) Initial and subsequent measurement is at fair value with subsequent changes in fair value recorded in earnings.

Note: In all cases above, the contracts must be reassessed at each reporting period in order to determine whether or not the contract must be reclassified.

Interpretive response: Yes. In certain circumstances an instrument that reflects an obligation to repurchase equity by transferring assets may be classified as an asset when the fair value of the contract puts the issuer in a gain position at the settlement date. For example, a forward purchase contract that an issuer must or can net-cash settle may be an asset or a liability of the issuer.

- Liability classification is required when the issuer is required to transfer assets because the fair value of the forward purchase contract at the settlement date places the issuer in a loss position.
- Asset classification is required when the issuer will receive assets because the fair value of the forward purchase contract at the settlement date places the issuer in a gain position.

However, other purchase contracts in the scope of this guidance are not classified as assets because the issuer is not entitled to receive assets from the holder under the terms of the contract.

For example, the issuer might have to transfer assets if the holder of a put option exercises its option, but the issuer will not have to transfer assets if that put option expires unexercised. In either case, except for the premium received for writing the option, the issuer is not entitled to receive assets from the holder. These contracts are generally classified as liabilities if they must or can be physically settled or must or can be net-cash settled.

6.6 Certain obligations to issue a variable number of shares



Excerpt from ASC 480-10

> Certain Obligations to Issue a Variable Number of Shares

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

- a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)
- b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares)
- c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).


See paragraph 480-10-55-21 for related implementation guidance.

6.6.10 Overview

The third, and final, class of instruments that require liability classification under Topic 480 is instruments that reflect obligations that the issuer must or can settle by issuing a variable number of its equity shares; see overview in section 6.1. This class is referred to throughout this section as ‘certain obligations to issue a variable number of shares’.

Topic 480 requires a financial instrument that reflects such an obligation to be classified as a liability if: [480-10-25-14]

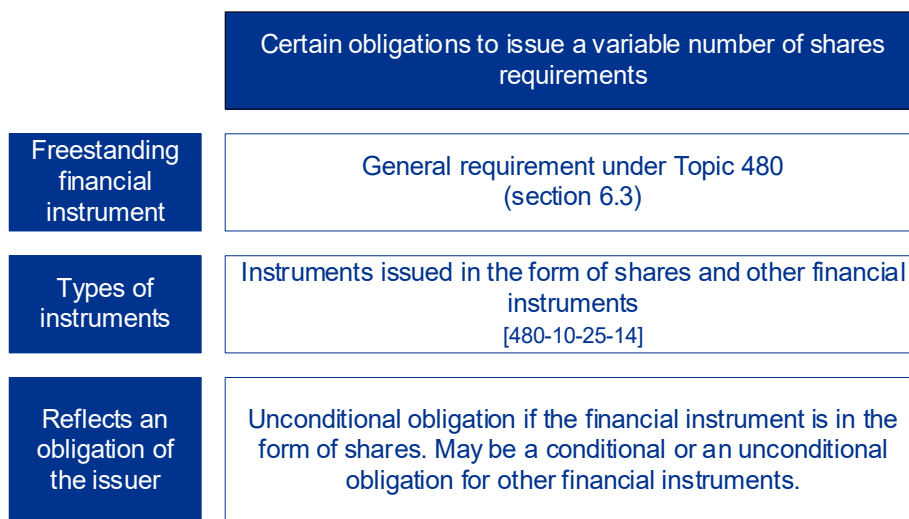
- the issuer must or may settle the instrument by issuing a variable number of its equity shares; and
- at inception, the monetary value of the obligation is based solely or predominantly on either a fixed monetary amount or a monetary amount determined in such a way that it does not expose the holder to the risks and rewards of ownership of the issuer’s equity shares.

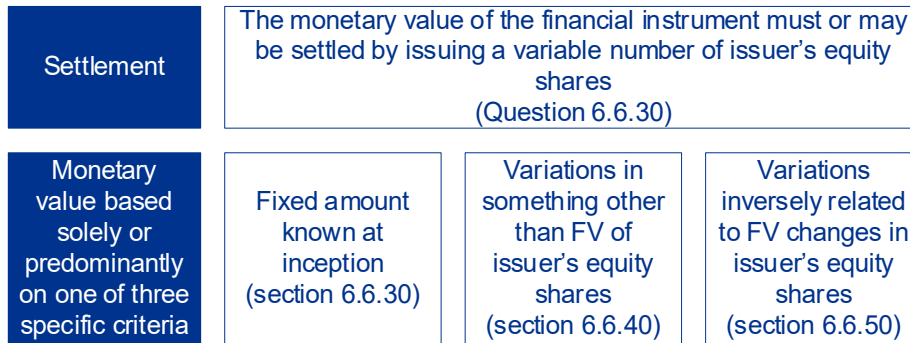


Question 6.6.10
How does an issuer determine whether an instrument is an obligation to issue a variable number of shares?

Interpretive response: The following diagram summarizes the criteria for determining whether an instrument reflects an obligation that the issuer must or can settle by issuing a variable number of its equity shares; see overview in section 6.1.

If it does not meet the criteria, it may still be in the scope of another class of financial instrument under Topic 480 (see Questions 6.4.10 and 6.5.10). If the instrument is not in the scope of Topic 480, an entity considers other US GAAP Topics, including the requirements related to temporary equity (see chapter 7) and contracts in an entity’s own equity, see chapter 8.





The diagram incorporates the two general requirements for financial instruments to be in the scope of Topic 480 (see section 6.2.10) – the financial instrument must be freestanding and reflect an obligation of the issuer. [480-10-25-8]

Whether an obligation is conditional or unconditional is an important distinction when determining whether the obligation is in the scope of the guidance for certain obligations to issue a variable number of shares (see Question 6.2.80). As shown in the diagram: [480-10-25-14]

- **financial instruments issued in the form of shares:** for these instruments, the obligation must be unconditional to be in this guidance's scope – e.g. convertible preferred shares that are required to be mandatorily converted to common shares at a certain date. As a result, financial instruments issued in the form of shares that embody conditional obligations to issue a variable number of shares (e.g. upon an IPO or a change of control) are not in its scope;
- **other financial instruments (i.e. other than those issued in the form of shares):** for these instruments, the obligation to issue a variable number of shares may be unconditional or conditional.

An instrument also must meet the remaining requirements in the diagram to be accounted for as an obligation to issue a variable number of shares as discussed in section 6.6. [480-10-25-14]

6.6.20 Monetary value: Basic principles



Excerpt from ASC 480-10

20 Glossary

Monetary Value

What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions.

05-4 For certain financial instruments, Section 480-10-25 requires consideration of whether **monetary value** would remain fixed or would vary in response to changes in market conditions.

05-5 How the monetary value of a financial instrument varies in response to changes in market conditions depends on the nature of the arrangement, including, in part, the form of settlement.





05-6 For purposes of this Subtopic, three related terms – shares, equity shares, and **issuer's equity shares** – are used in the particular ways defined in the glossary.

• > Monetary Value


55-2 Paragraph 480-10-05-5 explains that how the **monetary value** of a **financial instrument** varies in response to changes in market conditions depends on the nature of the arrangement, including, in part, the form of settlement. For example, for a financial instrument that embodies an **obligation** that requires:

- a. Settlement either by **transfer** of \$100,000 in cash or by issuance of \$100,000 worth of **equity shares**, the monetary value is fixed at \$100,000, even if the **share** price changes.
- b. **Physical settlement** by transfer of \$100,000 in cash in exchange for the issuer's equity shares, the monetary value is fixed at \$100,000, even if the **fair value** of the equity shares changes.
- c. **Net share settlement** by issuance of a variable number of shares based on the change in the fair value of a fixed number of the issuer's equity shares, the monetary value varies based on the number of shares required to be issued to satisfy the obligation. For example, if the exercise price of a net-share-settled written put option entitling the holder to put back 10,000 of the **issuer's equity shares** is \$11, and the fair value of the issuing entity's equity shares on the exercise date decreases from \$13 to \$10, that change in fair value of the **issuer's** shares increases the monetary value of that obligation at settlement from \$0 to \$10,000 (\$110,000 minus \$100,000), and the option would be settled by issuance of 1,000 shares (\$10,000 divided by \$10).
- d. **Net cash settlement** based on the change in the fair value of a fixed number of the issuer's equity shares, the monetary value varies in the same manner as in (c) for net share settlement, but the obligation is settled with cash. In a net-cash-settled variation of the previous example, the option would be settled by delivery of \$10,000.
- e. Settlement by issuance of a variable number of shares that is based on variations in something other than the issuer's equity shares, the monetary value varies based on changes in the price of another variable. For example, a net-share-settled obligation to deliver the number of shares equal in value at settlement to the change in fair value of 100 ounces of gold has a monetary value that varies based on the price of gold and not on the price of the issuer's equity shares.

Determining whether an instrument reflects an obligation to issue a variable number of shares in the meaning of Topic 480 requires an entity to consider whether monetary value will remain fixed or will vary in response to changes in market conditions.

In scope of Topic 480?			
 Monetary value is predominantly fixed¹	Monetary value predominantly varies...		
	 In response to changes other than changes in fair value of issuer's shares ¹	 Inversely to fair value of issuer's shares ¹	 In response to changes in fair value of issuer's shares
Note: 1. If other scope requirements under Topic 480 are met (see diagram in Question 6.6.10)			

This section explains how to determine monetary value, and sections 6.6.30 to 6.6.50 explain how to apply the concept of monetary value to instruments that require the issuer to issue a variable number of shares.




Question 6.6.20

What is the notion of monetary value and how is it relevant to Topic 480?

Interpretive response: Exposure to changes in the fair value of the issuer's equity shares is a characteristic of an ownership relationship because that fair value reflects the realizable benefits of owners that are in their control. Although an instrument may be settled by issuing equity shares, it has more characteristics of a liability than of equity if its monetary value does not fluctuate with changes in the value of the issuer's shares.

When a financial instrument's monetary value is fixed at inception, the holder is not subject to variations in the fair value of the issuer's equity; therefore, the instrument does not establish an ownership relationship. Similarly, when the monetary value varies based on something other than the value of the issuer's equity shares, it does not expose the holder to the risks and rewards of ownership of the issuer's equity shares and therefore does not establish an ownership relationship. [480-10-25-14, FAS 150.B42 – B43]

The notion of monetary value assists in determining whether the risks or benefits from changes in the fair value of the issuer's equity shares to which an instrument's holder is exposed are similar to those to which a holder of outstanding shares is exposed. [FAS 150.B38 – B39]



Example 6.6.10

Monetary value – instrument settleable in the issuer's shares

On April 1, Year 1, Issuer issues a financial instrument to Holder and receives \$95,000 in cash. The instrument matures in one year. At the maturity date, Issuer has the option of paying Holder \$100,000 in cash or a variable number of its common shares that have a fair value of \$100,000 at that date.

The monetary value is fixed at \$100,000. This means at the maturity date Holder will receive either \$100,000 in cash or a variable number of Issuer's common shares that have a fair value of \$100,000. Because the monetary value is fixed, the instrument is in the scope of Topic 480 if other requirements are met.



Question 6.6.30

On what basis is 'monetary value' determined?

Interpretive response: In determining whether a share-settled financial instrument is in the scope of Topic 480, an issuer evaluates the monetary value of the settlement. The focus of determining monetary value is the fair value of the cash, shares or other instruments that a financial instrument obligates the issuer to convey to the holder at the settlement date – i.e. the fair value the holder receives (issuer pays) at settlement. It is not based on the amount of cash or other consideration the holder pays (issuer receives) at settlement.

The term 'fair value' is used throughout Topic 480, including when defining monetary value. The definition of fair value in this Topic is consistent with its definition in Topic 820. See KPMG Handbook, [Fair value measurement](#).



Example 6.6.20

Monetary value – physically settled forward contract

On April 1, Year 1, Issuer enters into a forward contract to purchase 10,000 of its own common shares for \$100,000 in cash from Holder. The instrument settles in one year (March 31, Year 2) and physical settlement is required.

If Issuer's common shares are trading at \$15 per share on March 31, Year 2, Holder is required to provide shares with a fair value of \$150,000 (\$15 per share × 10,000 shares).

The calculation of monetary value focuses on the fair value that Holder receives (issuer pays) at settlement: \$100,000 in cash.

The fair value of the 10,000 common shares the holder relinquishes at settlement (Issuer receives) – which may vary throughout the term of the forward contract – is not relevant in determining monetary value.

Because the monetary value is fixed, the contract is in the scope of Topic 480 if other requirements are met.



Example 6.6.30

Monetary value – net-share settled written put option

On April 1, Year 1, Issuer writes a put option to Holder. Under the option, Holder has the right to sell (put) 10,000 Issuer common shares back to Issuer at a price of \$11. The instrument expires in one year and is settleable in net shares.

Because the written put is net-share settled, Holder receives a variable number of shares based on the change in fair value of 10,000 Issuer common shares. Therefore, the monetary value of the written put varies based on the number of shares Issuer must issue at the exercise date, which will depend on the fair value of the common shares at that date.

For example, if the fair value of Issuer common shares at the date Holder exercises the put option is \$10, the monetary value at settlement would be \$10,000: $(\$11 \text{ strike price} - \$10 \text{ fair value}) \times 10,000 \text{ shares}$. Issuer would settle the contract by issuing 1,000 common shares $(\$10,000 \div \$10)$ to Holder.



Example 6.6.40

Monetary value – net-cash settled written put option

On April 1, Year 1, Issuer writes a put option to Holder. Under the option, Holder has the right to sell (put) 10,000 Issuer common shares back to Issuer at a price of \$11. The instrument expires in one year and, if exercised, will settle net in cash.

Because Issuer will net-cash settle the option, Holder receives a variable amount of cash based on the change in fair value of 10,000 Issuer common shares. Therefore, the monetary value of the instrument varies based on changes in the fair value of Issuer's shares.

For example, if the fair value of Issuer common shares at the date Holder exercises the put option is \$10, the monetary value at settlement is \$10,000: $(\$11 \text{ strike price} - \$10 \text{ fair value}) \times 10,000 \text{ shares}$. Issuer settles the contract by paying \$10,000 in cash to Holder.

6.6.30 Monetary value based on fixed monetary amount



Excerpt from ASC 480-10

- • > Obligation to Issue Shares with Monetary Value Based on a Fixed Monetary Amount Known at Inception

55-22 Certain financial instruments embody obligations that require (or permit at the issuer's discretion) settlement by issuance of a variable number of the issuer's equity shares that have a value equal to a fixed monetary amount. For example, an entity may receive \$100,000 in exchange for a promise to issue a

sufficient number of its own shares to be worth \$110,000 at a future date. The number of shares required to be issued to settle that unconditional obligation is variable, because that number will be determined by the fair value of the issuer's equity shares on the date of settlement. Regardless of the fair value of the shares on the date of settlement, the holder will receive a fixed monetary value of \$110,000. Therefore, the instrument is classified as a liability under paragraph 480-10-25-14(a). Some share-settled obligations of this kind require that the variable number of shares to be issued be based on an average market price for the shares over a stated period of time, such as the average over the last 30 days before settlement, instead of the fair value of the issuer's equity shares on the date of settlement. Thus, if the average market price differs from the share price on the date of settlement, the monetary value of the obligation is not entirely fixed at inception and is based, in small part, on variations in the fair value of the issuer's equity shares. Although the monetary amount of the obligation at settlement may differ from the initial monetary value because it is tied to the change in fair value of the issuer's equity shares over the last 30 days before settlement, the monetary value of the obligation is predominantly based on a fixed monetary amount known at inception. The obligation is classified as a liability under paragraph 480-10-25-14(a). Upon issuance of the shares to settle the obligation, equity is increased by the amount of the liability and no gain or loss is recognized for the difference between the average and the ending market price.

• • > Unconditional Obligation that Must Be Either Redeemed for Cash or Settled by Issuing Shares

55-27 Some instruments do not require the issuer to transfer assets to settle the obligation but, instead, unconditionally require the issuer to settle the obligation either by transferring assets or by issuing a variable number of its equity shares. Because those instruments do not require the issuer to settle by transfer of assets, those instruments are not within the scope of paragraphs 480-10-25-4 through 25-6. However, those instruments may be classified as liabilities under paragraph 480-10-25-14.

55-28 For example, an entity may issue 1 million shares of cumulative preferred stock for cash equal to the stock's liquidation preference of \$25 per share. The entity is required either to redeem the shares on the fifth anniversary of issuance for the issuance price plus any accrued but unpaid dividends in cash or to settle by issuing sufficient shares of its common stock to be worth \$25 per share. Preferred stockholders are entitled to a mandatory dividend, payable quarterly at a rate of 6 percent per annum based on the \$25 per share liquidation preference (\$1.50 per share annually). The dividend is cumulative and is payable in cash or in a sufficient number of additional shares of the preferred stock based on the liquidation preference of \$25 per share. That obligation does not represent an unconditional obligation to transfer assets and, therefore, is not a mandatorily redeemable financial instrument subject to paragraph 480-10-25-4. But it is still a liability, under paragraph 480-10-25-14(a), because the preferred shares embody an unconditional obligation that the issuer may settle by issuing a variable number of its equity shares with a monetary value that is fixed and known at inception. Because the preferred shares are liabilities, payments to holders are reported as interest cost, and accrued but not-yet-paid payments are part of the liability for the shares.

To be classified as a liability under Topic 480, an obligation to issue a variable number of shares has to have a monetary value that is based on one of three criteria (see diagram in Question 6.6.10). Under the first criterion, monetary value is based solely or predominantly on a fixed amount that is known at the instrument's inception. [480-10-25-14(a)]



Example 6.6.50

Mandatorily convertible shares – variable vs fixed monetary value

Scenario 1: Variable monetary value

Issuer issues mandatorily convertible preferred shares on January 1, Year 1. The preferred shares will convert into 1,000 Issuer common shares on March 15, Year 9.

Issuer analyzes the instrument using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Unconditional obligation issued in form of shares	✓
Requires Issuer to settle by issuing fixed number of common shares	✗
Monetary value not fixed and known at inception	✗

The convertible shares are not an obligation to issue a variable number of shares under Topic 480 because they:

- do not require or permit Issuer to settle the unconditional obligation by issuing a variable number of its common shares – it will instead issue a fixed 1,000 common shares; and
- the monetary value at inception is variable because Holder will receive a value at settlement equal to 1,000 times the then-current Issuer common share price – i.e. the monetary value will vary directly with changes in the fair value of Issuer's common share price.

Scenario 2: Fixed monetary value

Issuer issues mandatorily convertible preferred shares on January 1, Year 1. The preferred shares will convert into a variable number of Issuer's common shares on March 15, Year 9 with a then fair value of \$1 million.

Issuer analyzes the instrument using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Unconditional obligation issued in form of shares	✓

Characteristic of the instrument	Criterion met?
Requires Issuer to settle by issuing variable number of common shares	✓
Monetary value fixed and known at inception	✓

The convertible shares are an obligation to issue a variable number of shares under Topic 480. The monetary value is fixed at inception because Holder will receive a value at settlement equal to \$1 million, regardless of the then-current Issuer common share price. Holder is not exposed to the risks and rewards of ownership.



Example 6.6.60 Stock-settled debt

On January 1, Year 1, Issuer issues a debt instrument to Holder in exchange for \$95,000. The instrument requires Issuer to deliver on December 31, Year 1 a variable number of its common shares to Holder that have a fair value of \$100,000.

The analysis in Example 6.6.50 Scenario 2 applies to this example. That example involves convertible shares and this example involves share-settled debt. However, there is no qualitative difference between these two instruments when analyzing their monetary value. Therefore, the monetary value of the stock-settled debt in this example is fixed because Holder receives \$100,000 of value at settlement, regardless of changes in the fair value of Issuer's common shares.



Question 6.6.40 Is the monetary value 'fixed' if it is based on an average market price over a period of time?

Interpretive response: It depends. Some share-settled obligations base the variable number of shares to be issued on an average market price for the shares over a stated period (e.g. the average over the 30 days before settlement) instead of the fair value of the issuer's equity shares on the date of settlement. If the average market price differs from the share price on the date of settlement, the monetary value of the obligation is not entirely fixed at inception and is based, in small part, on variations in the fair value of the issuer's equity shares. [\[480-10-55-22\]](#)

The amount of the obligation at settlement may differ from the initial monetary value because it is tied to the change in fair value of the issuer's equity shares over the last 30 days before settlement. However, the monetary value of the obligation is predominantly based on a fixed monetary amount known at inception. Therefore, the obligation is classified as a liability under Topic 480. [\[480-10-25-14\(a\), 55-22\]](#)



Question 6.6.45**

What does an issuer evaluate to determine the appropriate classification of a Simple Agreement for Future Equity?

Background: A Simple Agreement for Future Equity (SAFE) is a type of equity financing in which an issuer gives the holder the right to obtain the issuer’s shares upon the occurrence of a future event, in exchange for an upfront payment. Triggering events that result in the conversion of the SAFE into shares may include an equity financing, a change in control, or an IPO.

Interpretive response: An issuer evaluates each of the features of the instrument to determine the appropriate classification of a SAFE. Common features of a SAFE include:

- a monetary value fixed at inception; and
- an obligation for the issuer to issue a variable number of shares upon the occurrence of a future event.

Because a SAFE is an agreement to provide a future equity stake if a triggering event occurs, it does not typically meet the legal form of an outstanding share and, therefore, is not classified as equity.

If a SAFE is legal form debt, it is liability classified. However, if an issuer determines a SAFE is not in the legal form of debt, it should be evaluated for liability classification under Topic 480.

6.6.40 Monetary value based on variations in something other than fair value of issuer’s equity shares



Excerpt from ASC 480-10

- > Obligation to Issue Shares with Monetary Value Based on Something Other than Changes in the Fair Value of the Issuer's Equity

55-23 An entity’s guarantee of the value of an asset, liability, or equity security of another entity may require or permit settlement in the entity’s equity shares. For example, an entity may guarantee that the value of a counterparty’s equity investment in another entity will not fall below a specified level. The guarantee contract requires that the guarantor stand ready to issue a variable number of its shares whose fair value equals the deficiency, if any, on a specified date between the guaranteed value of the investment and its current fair value. Upon issuance, unless the guarantee is accounted for as a derivative instrument, the obligation to stand ready to perform is a liability addressed by Topic 460. If, during the period the contract is outstanding, the fair value of the guaranteed investment falls below the specified level, absent an increase in value, the guarantor will be required to issue its equity shares. At that point in time, the liability recognized in accordance with that Topic would be subject to the requirements of Topic 450. This Subtopic establishes that, even though the

loss contingency is settleable in equity shares, the obligation under that Topic is a liability under paragraph 480-10-25-14(b) until the guarantor settles the obligation by issuing its shares. That is because the guarantor's conditional obligation to issue shares is based on the value of the counterparty's equity investment in another entity and not on changes in the fair value of the guarantor's equity instruments.

55-24 If this example were altered so that the monetary value of the obligation is based on the deficiency on a specified date between the guaranteed value of the investment in another entity and its current fair value plus .005 times the change in value of 100 of the guarantor's equity shares, the monetary value of the obligation would not be solely based on variations in something other than the fair value of the issuer's (guarantor's) equity shares.

55-25 However, the monetary value of the obligation would be predominantly based on variations in something other than the fair value of the issuer's (guarantor's) equity shares and, therefore, the obligation would be classified as a liability under paragraph 480-10-25-14(b). That obligation differs in degree from the obligation under a contract that is indexed in part to the issuer's shares and in part (but not predominantly) to something other than the issuer's shares (commonly called a dual-indexed obligation). The latter contract is not within the scope of this Subtopic. That paragraph applies only if the monetary value of an obligation to issue equity shares is based solely or predominantly on variations in something other than the fair value of the issuer's equity shares. For example, an instrument meeting the definition of a derivative instrument that requires delivery of a variable number of the issuer's equity shares with a monetary value equaling changes in the price of a fixed number of the issuer's shares multiplied by the Euro/U.S. dollar exchange rate embodies an obligation with a monetary value that is based on variations in both the issuer's share price and the foreign exchange rate and, therefore, is not within the scope of this Subtopic. (However, that instrument would be a derivative instrument under Topic 815. Paragraphs 815-10-15-74[a] and 815-10-15-75[b] address derivative instruments that are dual indexed and require an issuer to report those instruments as derivative instrument liabilities or assets.)

To be classified as a liability under Topic 480, an obligation to issue a variable number of shares has to have a monetary value that is based on one of three criteria. Under the second criterion, monetary value is based on variations in something other than the fair value of the issuer's equity shares.

The monetary value of certain instruments may be based solely or predominantly on variations in something other than the fair value of the issuer's equity shares. [\[480-10-25-14\(b\)\]](#)



Question 6.6.50

How can the monetary value vary based on something other than the fair value of the issuer's equity shares?

Interpretive response: Under the guidance for certain obligations to issue a variable number of shares, monetary value may be based on variations in something other than the issuer's equity (e.g. a change in the S&P 500 index). When these types of variables determine the number of shares a holder receives, the fair value the holder receives is unrelated to changes in the fair value of the issuer's equity shares. Therefore, the holder does not benefit like an equity owner would if the fair value of the issuer's equity shares increases. Correspondingly, the holder does not bear the risk that an equity owner would if the fair value of those shares decreases. [480-10-25-14(b)]

Therefore, even though the issuer will settle its obligation by issuing equity shares, the instrument has more characteristics of a liability than of equity because the holder's return is unrelated to changes in the fair value of the issuer's equity shares. [480-10-25-14(b)]



Example 6.6.70 S&P call option

On January 1, Year 1, Issuer writes an option contract to Holder. The contract provides that, upon exercise by Holder, Issuer will deliver a variable number of its common shares to Holder that will have a fair value equal to any decrease in the S&P 500 Index from January 1, Year 1 to June 30, Year 1.

Issuer analyzes the instrument using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Conditional obligation that is not an outstanding share	✓
Requires Issuer to settle by issuing variable number of common shares	✓
Monetary value based on variation in something other than fair value of Issuer's equity (decrease in S&P Index)	✓

The written option is a conditional obligation to issue a variable number of shares under Topic 480, and Issuer will account for the written option as a liability even though it will settle the obligation by issuing its own equity shares.

Issuer classifies the written option as a liability under Topic 480 because it does not establish an ownership relationship for Holder. Even though Issuer will settle the obligation by issuing its own equity shares, the written option has more characteristics of a liability than of equity because Holder's return is not

based on, and is unrelated to, changes in the fair value of Issuer’s equity shares.



Example 6.6.80

Monetary value based on price of gold – net-share settled contract

On April 1, Year 1, Issuer writes a put option to Holder. Under the option, Holder has the right to sell (put) 100 ounces of gold to Issuer at a strike price of \$175,000. The instrument expires in one year and, if exercised, will settle by Holder receiving a variable number of Issuer common shares that have a fair value at the settlement date equal to the difference between the strike price of the put option (\$175,000) and the fair value of 100 ounces of gold at the settlement date.

Issuer analyzes the instrument using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Conditional obligation that is not an outstanding share	✓
Requires Issuer to settle by issuing variable number of common shares	✓
Monetary value based on variation in something other than fair value of issuer’s equity (fair value of gold)	✓

The written put option is a conditional obligation to issue a variable number of shares under Topic 480, and Issuer will account for the written put as a liability even though it will settle the obligation by issuing its own equity shares.

Issuer will net-share settle the option by issuing to Holder a variable number of shares based on the change in fair value of 100 ounces of gold. Therefore, the monetary value of the instrument varies based on the change in the price of gold.

For example, if the fair value of 100 ounces of gold is \$150,000 and the common share price of Issuer common shares is \$100 at the date Holder exercises the put option, the monetary value at settlement would be \$25,000: \$175,000 strike price of the option – \$150,000 fair value of gold. Issuer would settle the contract by issuing 250 shares (\$25,000 ÷ \$100 per share) to Holder.



Question 6.6.60

Does Topic 480 apply to a guarantee that requires settlement by equity shares?

Interpretive response: Yes. An entity’s guarantee of the value of an asset, liability or equity security of another entity may require or permit settlement in

the guarantor’s equity shares. Under Topic 460 (guarantees), a guarantee obligates the guarantor (issuer) to:

- stand ready to perform over the term of the guarantee in the event a specified triggering event or condition occurs (noncontingent aspect); and
- make contingent future payments if those triggering events or conditions occur (contingent aspect).

Unless the guarantee qualifies as a derivative, the guarantor accounts for its obligation to stand ready to perform (noncontingent aspect) under Topic 460 and accounts for a conditional obligation to issue equity shares under Topic 480 (contingent aspect). [460-10-25-2, 480-10-55-23]



Example 6.6.90 Value guarantee

Scenario 1: Monetary value based solely on variation in something other than fair value of issuer’s equity shares

Issuer guarantees that the value of Holder’s equity investment in XYZ Corp. will not fall below a specified level. The guarantee contract requires that Issuer stand ready to issue a variable number of its equity shares. The variable number of shares will have a fair value that equals the deficiency, if any, on a specified date between the guaranteed value of Holder’s investment and its current fair value.

Issuer analyzes the contingent aspect of the guarantee under Topic 480 using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Conditional obligation that is not an outstanding share	✓
Requires Issuer to settle by issuing variable number of common shares	✓
Monetary value based on variation other than change in Issuer’s equity (decrease in XYZ’s share price)	✓

This guarantee reflects an obligation to issue a variable number of shares under Topic 480. The monetary value is based on a decrease in the fair value of an investment in XYZ and not tied to the fair value of Issuer’s shares.

If the guarantee meets the definition of a derivative and does not meet the guarantee scope exception in Topic 815, Issuer accounts for the guarantee as a derivative. Otherwise, Issuer accounts for the stand-ready obligation (noncontingent aspect) under Topic 460 and the obligation to issue shares (contingent aspect) under Topic 480.

Even though the loss contingency is settleable in equity shares, the obligation is a liability under Topic 480 under the guidance for accounting for certain obligations to issue a variable number of shares until Issuer settles the

obligation by issuing its shares. The liability exists because Issuer’s conditional obligation to issue equity shares is based on the value of Holder’s equity investment in XYZ and not on changes in the fair value of Issuer’s equity instruments.

Scenario 2: Monetary value based predominantly on variation in something other than fair value of issuer’s equity shares

Scenario 2 assumes that the monetary value of the guarantee contract in Scenario 1 is based on the following:

- the deficiency on a specified date between the guaranteed value of Holder’s investment in XYZ and its current fair value; plus
- .005 times the change in value of 100 of Issuer’s equity shares.

Issuer analyzes the instrument using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Conditional obligation that is not an outstanding share	✓
Requires Issuer to settle by issuing variable number of common shares	✓
Monetary value based predominantly on variation other than change in Issuer’s equity	✓

Like Scenario 1, this guarantee reflects an obligation to issue a variable number of shares under Topic 480.

Unlike Scenario 1, the monetary value is predominantly, but not solely, based on a decrease in the fair value of Holder’s investment in XYZ. The additional settlement provision based on .005 times the change in value of 100 of Issuer’s equity shares is not significant enough to cause the criterion not to be met.

6.6.50 Monetary value based on variations inversely related to changes in fair value of issuer’s equity shares

Excerpt from ASC 480-10

- > Obligation to Issue Shares with Monetary Value Based on Variations Inversely Related to Changes in the Fair Value of the Issuer’s Equity Shares

55-26 A freestanding forward purchase contract, a freestanding written put option, or a net written option (otherwise similar to the example in paragraphs 480-10-55-18 through 55-19) that must or may be net share settled is a liability under paragraph 480-10-25-14(c), because the monetary value of the obligation to deliver a variable number of shares embodied in the contract varies inversely in relation to changes in the fair value of the issuer’s equity shares; when the issuer’s share price decreases, the issuer’s obligation under those contracts

increases. Such a contract is measured initially and subsequently at fair value (with changes in fair value recognized in earnings) and classified as a liability or an asset, depending on the fair value of the contract on the reporting date. A net written or net purchased option or a zero-cost collar similar to the examples in paragraphs 480-10-55-18 through 55-20 that must or may be net share settled is classified as a liability (or asset) under paragraph 480-10-25-14(c), because the monetary value of the issuer's obligation to deliver a variable number of shares under the written put option varies inversely in relation to changes in the fair value of the issuer's share price. The purchased call option element of that freestanding instrument does not embody an obligation to deliver a variable number of shares and does not affect the classification of the entire instrument when applying that paragraph. In addition, a freestanding purchased call option is not within the scope of this Subtopic because it does not embody an obligation.

To be classified as a liability under Topic 480, an obligation to issue a variable number of shares has to have a monetary value that is based on one of three criteria. Under the third factor, monetary value is based on variations inversely related to changes in fair value of the issuer's equity shares.

The monetary value of certain instruments may be based solely or predominantly on an inverse relationship between changes in the fair value of the issuer's equity shares and the value the holder will receive in shares. In such instruments, the fair value of what the holder receives generally increases as the issuer's equity shares decrease in fair value and vice versa. Said another way, the holder generally bears an inverse risk to the risk borne by an existing ownership interest in the entity. [\[480-10-25-14\(c\)\]](#)

Contracts where the monetary value varies inversely with changes in fair value of the issuer's equity shares may include forward purchase contracts, written put options and net written (or purchased or zero-cost) options or collars that require or permit net-share settlement. Even though the issuer will issue equity shares to settle the obligation, these instruments do not establish an ownership relationship with the holder.

Examples 6.6.100 to 6.6.130 illustrate how to determine whether forward contracts and put options have monetary values that are based on variations inversely related to changes in an entity's equity shares.



Example 6.6.100 Forward purchase contract

On March 1, Year 1, ABC Corp. enters into a forward contract with DEF Corp. to purchase 50 of its own equity shares on March 1, Year 2, based on the following terms at that date.

Equity share price is:	Then ABC:
> \$20	Receives ABC shares with FV = 50 × (share price – \$20)
< \$20	Delivers ABC shares with FV = 50 × (\$20 – share price)

As shown in the following table, the monetary value of the shares ABC must convey to DEF increases as ABC's common share price decreases.

F V ↓	If March 1, Year 2 equity share price is	Monetary value of shares ABC conveys to DEF	↑ M V
	\$20	\$ 0	
	\$18	\$100	
	\$16	\$200	
	\$14	\$300	

ABC analyzes the instrument using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Conditional obligation that is not an outstanding share	✓
Requires ABC to settle by issuing variable number of common shares	✓
Monetary value varies inversely with changes in fair value of ABC's equity	✓

The forward contract is in the scope of Topic 480 for certain obligations to issue a variable number of shares. It has a monetary value at inception that is based solely on variations inversely related to changes in the fair value of its common shares. In this example, the obligation is conditional because ABC may not be required to settle the instrument by transferring a variable number of its equity shares in all cases – i.e. ABC will receive a variable number of its equity shares if its equity share price is greater than \$20 at settlement. However, the forward contract is in the scope of the guidance for certain obligations to issue a variable number of shares because, at inception, it may require ABC to settle by transferring a variable number of its shares. [480-10-25-14(c)]





Example 6.6.110 Forward sale contract

On March 1, Year 1, ABC Corp. enters into a forward contract with DEF Inc. to sell 50 of its own shares on March 1, Year 2, based on the following terms at that date.

Equity share price is:	Then ABC:
< \$20	Receives ABC shares with FV = 50 × (\$20 – share price)
> \$20	Delivers ABC shares with FV = 50 × (share price – \$20)

As shown in the following table, the monetary value of the shares ABC must convey to DEF increases as ABC's common share price increases.

	If March 1, Year 2 common share price is	Monetary value of shares ABC would convey to DEF
	\$20	\$ 0
	\$22	\$100
	\$24	\$200
	\$26	\$300
		

ABC analyzes the instrument using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Conditional obligation that is not an outstanding share	✓
Requires ABC to settle by issuing variable number of common shares	✓
Monetary value varies inversely with changes in fair value of ABC's equity	✗

The forward contract meets some of the requirements of an obligation to issue a variable number of shares under Topic 480. In this example, the obligation is conditional because ABC may not be required to settle the instrument by transferring a variable number of its equity shares in all cases. However, the forward contract is not classified as a liability because the monetary value at inception is based solely on variations that correspond to changes in the fair value of its common shares.




Example 6.6.120 Written put option

On March 1, Year 1, ABC Corp. writes an option contract to DEF Corp. The terms of the contract allow DEF at its option to sell (put) 50 of ABC's equity shares to ABC at any time during the next year, based on the following terms at that date.


Equity share price is:	Then ABC:
< \$20	Delivers ABC shares with FV = 50 × (\$20 – share price)

As shown in the following table, the monetary value of the shares ABC must convey to DEF increases as ABC's common share price decreases:

If common share price is	Monetary value of shares ABC would convey to DEF
\$20	\$ 0
\$18	\$100
\$16	\$200
\$14	\$300



F
V



M
V

ABC analyzes the instrument using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Conditional obligation is not an outstanding share	✓
Requires ABC to settle by issuing variable number of common shares	✓
Monetary value varies inversely with changes in fair value of ABC's equity	✓

The written put is in the scope of Topic 480's guidance on certain obligations to issue a variable number of shares. In this example, the obligation is conditional because ABC may not be required to settle the instrument by transferring a variable number of its equity shares in all cases. It has a monetary value, at inception, that is based solely on variations inversely related to changes in the fair value of its common shares – if DEF exercises the option and ABC's common share price is less than \$20, ABC is required to transfer a variable number of its shares.





Example 6.6.130 Written call option

On March 1, Year 1, ABC Corp. writes an option contract that allows DEF Corp., at its option, to buy (call) 50 of ABC's common shares from ABC at any time during the next year, based on the following terms at that date.

Equity share price is:	Then ABC:
> \$20	Delivers ABC shares with FV = 50 × (share price – \$20)

As shown in the following table, the monetary value of the shares ABC must convey to DEF increases as ABC's common share price increases:

	If common share price is	Monetary value of shares ABC would convey to DEF
	\$20	\$ 0
	\$22	\$100
	\$24	\$200
	\$26	\$300
		

This table analyzes the instrument using the diagram in Question 6.6.10.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Conditional obligation (not an outstanding share)	✓
Requires ABC to settle by issuing variable number of common shares	✓
Monetary value varies inversely with changes in fair value of ABC's equity	✗

The written call meets some of the requirements of Topic 480's guidance on certain obligations to issue a variable number of shares. However, the written call option is not classified as a liability because the monetary value at inception is based solely on variations that correspond to changes in the fair value of its common shares. If ABC's share price is greater than \$20, ABC is required to transfer a variable number of its common shares with a monetary value equal to 50 times the amount above \$20.



Question 6.6.70

Can written put options and forward purchase contracts on an issuer's own equity shares be accounted for as derivatives under Topic 815?

Interpretive response: No. Written put options on an issuer's own equity shares and forward purchase contracts on an issuer's own equity shares are always in the scope of Topic 480. This is regardless of whether they are physically settled, net-cash settled or net-share settled.

- **Physically settled or net-cash settled.** In the scope of Topic 480 because they are obligations to repurchase an issuer's equity shares by transferring assets (see section 6.5).
- **Net-share settled.** In the scope of Topic 480 as obligations to issue a variable number of shares.

Topic 815 permits hedge accounting only if the hedging instrument is a derivative instrument (or debt instruments in limited instances) and only if either the hedged item is an asset or liability or the forecasted transaction presents an exposure to variations in cash flows that could affect reported earnings, none of

which is the case with share repurchase programs. KPMG Handbook, [Derivatives and hedging](#), addresses hedging requirements under Topic 815.

6.6.60 Solely or predominantly based

As discussed in sections 6.6.20 to 6.6.50, for an instrument to be an obligation to issue a variable number of shares in the scope of Topic 480, the monetary value of those shares needs to be solely or predominantly based on one of three criteria: [480-10-25-14]

- a fixed monetary amount known at inception (section 6.6.30);
- variations in something other than the fair value of the issuer's equity shares (section 6.6.40); or
- variations inversely related to changes in the fair value of the issuer's equity shares (section 6.6.50).



Question 6.6.80

Why was the 'predominant' criterion added to the 'solely based on' criterion in assessing monetary value under this guidance?

Interpretive response: The 'predominant' criterion is an anti-abuse criterion that prevents instruments from being constructed to avoid Topic 480's scope. For example, an entity could embed a small amount of monetary value variation in response to changes in the fair value of its equity shares to avoid Topic 480 requirements, even though the overall variations would predominantly respond to something other than the entity's equity shares. [FAS 150.B46-B47]

This is similar to the anti-abuse requirement for nonsubstantive or minimal features in a financial instrument to be ignored for purposes of determining whether an instrument is in the scope of Topic 480 (see section 6.2.40).



Question 6.6.90

How does an issuer determine whether a monetary value is predominantly based on one of the three criteria under Topic 480?

Interpretive response: Determining whether the monetary value of a financial instrument is based solely on one or more of the three criteria may be relatively straightforward in many cases. However, judgment is required to distinguish between:

- instruments with monetary values predominantly based on one of those three criteria; and
- instruments that are excluded from Topic 480's scope because they have monetary values that are indexed both to the issuer's equity shares and to one or more other criteria.

We believe an issuer must take into account the individual facts and circumstances of each instrument when determining whether the monetary value is predominantly based on one or more of the three criteria. In performing this analysis, we believe the term 'predominantly' is similar to the concept of more likely than not (i.e. greater than 50%). Therefore, if at inception it is more likely than not that the instrument will settle in such a way that the monetary value will be consistent with one of the three criteria, the instrument is in the scope of Topic 480 for certain obligations to issue a variable number of shares (assuming the other criteria are met).



Example 6.6.140 Analysis of predominance

Issuer issues mandatorily convertible preferred shares on January 1, Year 1 for \$1 million. Preferred dividends are payable quarterly at an annual rate of return of 8%.

Holder has the option to convert the instrument into 1,000 Issuer common shares throughout the life of the instrument. However, if Holder does not exercise the conversion feature by December 31, Year 9, Issuer is required to redeem the instrument in exchange for a variable number of its common shares with a then-current value of \$1 million – except that Issuer will issue a minimum and a maximum of 1,000 shares and 1,200 shares, respectively. Issuer's share price is \$900 at inception of the contract.

Issuer analyzes the convertible preferred shares under Topic 480's guidance on certain obligations to issue a variable number of shares to determine whether settlement is based predominantly on a fixed monetary amount known at contract inception.

The convertible preferred shares represent an unconditional obligation that must be settled by a certain date with a variable number of shares. The fact that Holder may accelerate conversion does not change the unconditional nature of the obligation. This unconditional obligation has two alternative aspects.

- **Fixed monetary value.** If the share price at the mandatory conversion date is between \$833.33 ($\$1 \text{ million} \div 1,200 \text{ shares}$) and \$1,000 ($\$1 \text{ million} \div 1,000 \text{ shares}$), the preferred shares will settle for a fixed monetary value of \$1 million.
- **Equity participation feature.** If the share price lies outside of this range at the mandatory conversion date, Holder will participate (to a greater or lesser extent) directly in the increase or decrease in Issuer's equity price.

Issuer analyzes the convertible preferred shares at inception to determine whether the fixed monetary value or the equity participation feature is predominant. We believe that predominance should be assessed based on whether it is more likely than not that the instrument will settle for a fixed monetary amount known at inception (see Question 6.6.100).

For the instrument described in this example, we believe Issuer should assess:

- the range of share prices for which settlement would be based on the fixed monetary amount;

- the expected volatility and expected future value of its equity shares; and
- the term of the instrument.

Generally, an entity performs a Monte Carlo or other simulation to determine predominance instead of using a risk-neutral model such as the Black-Scholes model. Risk-neutral models are oriented toward valuation instead of share price path prediction. Therefore, we believe risk-neutral models will generally not produce relevant information for determining predominance.

If the analysis indicates that there is more than a 50% chance that the instrument will convert when the share price is outside of the fixed monetary value range (i.e. \$833.33 to \$1,000 per share), the equity participation feature is predominant and Topic 480 does not apply. In that case, Issuer analyzes the instrument under other US GAAP to determine the appropriate classification (see below).

If the analysis indicates that there is *not* more than a 50% chance that the preferred shares will convert when the share price is within the fixed monetary value range (i.e. \$833.33 to \$1,000 per share), the fixed monetary value is predominant and Issuer classifies the convertible shares as a liability under Topic 480.

Subsequent to initial recognition, Issuer recognizes the changes in the shares' fair value in earnings for that period. In determining fair value, Issuer considers the current fair value of the embedded cap and floor inherent in the range of conversion ratios and, after issuance the value of the preferred shares could vary from par, accreted value, or intrinsic value depending on the fair value of those embedded features at each reporting date.

Considering other guidance, including temporary equity classification

If the instrument is not a Topic 480 liability, it does not mean that permanent equity classification is necessarily appropriate. Instead, Issuer considers whether it is capable of delivering equity shares at conversion. Factors it considers in making this assessment include whether:

- it has sufficient authorized and unissued shares available to satisfy its share obligations under the contract;
- there is a limit on the number of shares that might be issued under the contract; and
- it is obligated to deliver registered shares (delivery of which may not be in its unilateral control).

Although Subtopic 815-40 does not apply to a convertible share, it lists factors that should be considered when assessing whether delivery of shares at conversion is in the entity's control for purposes of applying the guidance for temporary equity in Topic 480 (see chapter 7). If share settlement is not fully controlled by Issuer, temporary equity classification for the instrument may be required if Issuer is an SEC registrant. Further, Issuer must also assess whether an equity-classified instrument (whether classified in permanent or temporary equity) contains embedded derivatives that require separation under Topic 815.



Example 6.6.150

Variable share forward sale contract

On January 1, Year 1, Issuer enters into a forward sale contract whereby it will issue a variable number of its common shares to Holder in exchange for a fixed amount of cash on December 31, Year 1 equaling \$1 million.

The number of shares Issuer will deliver is variable and will be determined by reference to Issuer's common share price on December 31, Year 1 as follows:

- one share if the market price of the common share is less than or equal to \$10;
- 0.65 shares if the market price of the common share is greater than or equal to \$15.38; or
- (x/y) shares if the market price of the common share is greater than \$10 and less than \$15.38 (whereby x is the implied price in the contract (\$10) and y is the market value of the common share).

If the share price on December 31, Year 1 is less than or equal to \$10 or greater than or equal to \$15.38 then the variable number of equity shares Holder will receive at maturity will have a fair value at that time that predominantly moves in the same direction as market value changes of the underlying common shares of Issuer from inception of the contract. Therefore, Holder is exposed to similar risks and rewards as an existing shareholder.

However, if Issuer's share price at settlement is greater than \$10 and less than \$15.38, Issuer will have an obligation to issue a variable number of shares based on a fixed monetary amount known at inception.

Issuer is required to analyze the forward contract, at inception, to assess whether it is more likely than not that the forward contract will be settled by issuing a variable number of Issuer's common shares based on a fixed monetary amount known at inception. This means at inception Issuer is required to determine whether it is more likely than not that the common share price on December 31, Year 1 will be between \$10 and \$15.38, based on whether the number of share price paths from the simulation are inside or outside of the fixed monetary value range.

If the analysis indicates that there is not more than a 50% chance that Issuer's common share price will be between \$10 and \$15.38 at settlement, the instrument is not in the scope of Topic 480's guidance on certain obligations to issue a variable number of shares. This is because the monetary value at inception is based predominantly on variations directly related to changes in the fair value of its common shares. This is the result even though the forward contract:

- reflects an unconditional obligation; and
- may require the issuer to settle the obligation by transferring a variable number of its common shares.

If the analysis indicates that there is *not* more than a 50% chance that Issuer's common share price on December 31, Year 1 will be between \$10 and \$15.38, the monetary value is predominantly based upon a fixed monetary amount known at inception. Therefore, the forward contract has a fixed monetary amount known at inception and is in the scope of Topic 480.



Question 6.6.100

How does an issuer analyze an instrument if there are two potential outcomes for which it may be obligated to perform?

Interpretive response: An instrument contains two potential outcomes in which the issuer will be obligated to perform if it allows the holder either:

- to purchase a fixed number of the issuer's shares at a fixed price; or
- to compel the issuer to reacquire the instrument at a fixed date for a variable number of shares equal to a fixed monetary amount known at inception.

The holder's choice and the outcome will depend on the issuer's share price at the settlement date.

To determine whether the instrument is in the scope of the guidance for certain obligations to issue a variable number of shares, the issuer must analyze the instrument at inception and consider all possible outcomes to judge which obligation is predominant:

- issuing a fixed number of the issuer's shares at a fixed price; or
- reacquiring the instrument and delivering a variable number of its shares with a fixed monetary amount.

If the issuer judges the obligation to issue a variable number of shares based on a fixed monetary amount known at inception to be predominant, the instrument is a liability under the guidance for certain obligations to issue a variable number of shares. Otherwise, the instrument is not a liability under Topic 480. [480-10-25-14(a)]

Section 6.10.30 discusses freestanding financial instruments involving multiple components with the same counterparty. [480-10-55-29 – 55-32, 55-42 – 55-52]

6.6.70 Asset classification

As with the guidance discussed in section 6.5, an instrument in the scope of Topic 480 is generally classified as a liability. However, an instrument in the scope of Topic 480's guidance on certain obligations to issue a variable number of shares may be classified, in certain circumstances, as an asset.



Question 6.6.110

How is a forward purchase contract or written put option on an issuer's equity shares classified if it must or can be net-share settled?

Interpretive response: A forward purchase contract on an issuer's equity shares that must or can be net-share settled may be either an asset or a liability. The forward purchase contract is a liability if it requires the issuer to transfer a variable number of its equity shares if the fair value of the contract at the

settlement date places the issuer in a loss position. In contrast, it is an asset if it requires that the issuer receive a variable number of shares if the fair value of the contract at the settlement date places the issuer in a gain position. [480-10-25-12, 25-14]

Similar to the discussion in section 6.5.30, other instruments in the scope of Topic 480 (such as a written put option) also reflect obligations that are conditional but cannot be classified as assets in any circumstances. For example, a written put option would never be an asset to the put writer because it only obligates the writer to perform (albeit conditionally). Except for the premium received for writing the option, the option writer is not entitled to receive any consideration. Therefore, these contracts that are in the scope of the guidance for certain obligations to issue a variable number of shares that must or can be net-share settled will be a liability for the issuer.

6.7 Presentation

6.7.10 Overview



Excerpt from ASC 480-10

> Presentation

45-1 Items within the scope of this Subtopic shall be presented as liabilities (or assets in some circumstances). Those items shall not be presented between the liabilities section and the equity section of the statement of financial position.



Question 6.7.10

Can an entity present a financial instrument that is in the scope of Topic 480 as temporary equity?

Interpretive response: No. An entity cannot present a financial instrument that is in the scope of Topic 480 in the 'temporary equity' or 'mezzanine' section of the balance sheet (between liabilities and equity). An entity is required to classify all freestanding financial instruments that are in the scope of Topic 480 as liabilities (or assets in some circumstances). [480-10-45-1]

SEC registrants continue to be subject to the temporary equity guidance and its related interpretations for instruments that are not in the scope of Topic 480, such as puttable shares. The temporary equity guidance requires securities with redemption features outside the control of the issuer to be classified outside of permanent equity. See chapter 7.

6.7.20 Balance sheet classification

Mandatorily redeemable instruments in the scope of Topic 480 are always classified as liabilities (see section 6.4). Other instruments in the scope of Topic 480 may, under certain circumstances, be classified on the balance sheet as assets or liabilities (see sections 6.5 and 6.6).



Question 6.7.20

Are financial instruments in the scope of Topic 480 classified as current or noncurrent liabilities?

Interpretive response: An entity that presents a classified balance sheet is required to present its assets and liabilities as current or noncurrent. Determining whether an instrument that is classified as a liability is presented as current or noncurrent is based on the requirements of Topic 210 and Topic 470 (see section 3.6).

6.8 Interaction with other standards

6.8.10 Contingent consideration in a business combination



Excerpt from ASC 480-10

> Interaction with Business Combinations

15-9 Subtopic 805-30 provides guidance on the recognition and initial measurement of consideration issued in a business combination, including contingent consideration.

15-10 However, when recognized, a financial instrument within the scope of this Topic that is issued as consideration (whether contingent or noncontingent) in a business combination shall be classified pursuant to the requirements of this Topic.

> Contingent Consideration in a Business Combination

35-4A Contingent consideration issued in a business combination that is classified as a liability in accordance with the requirements of this Topic shall be subsequently measured at fair value in accordance with 805-30-35-1.

A financial instrument that is issued as consideration in a business combination may be classified as a liability if it falls in one of the Topic 480 classes of financial instruments (see section 6.2.10). [\[805-30-25-6 – 25-7\]](#)

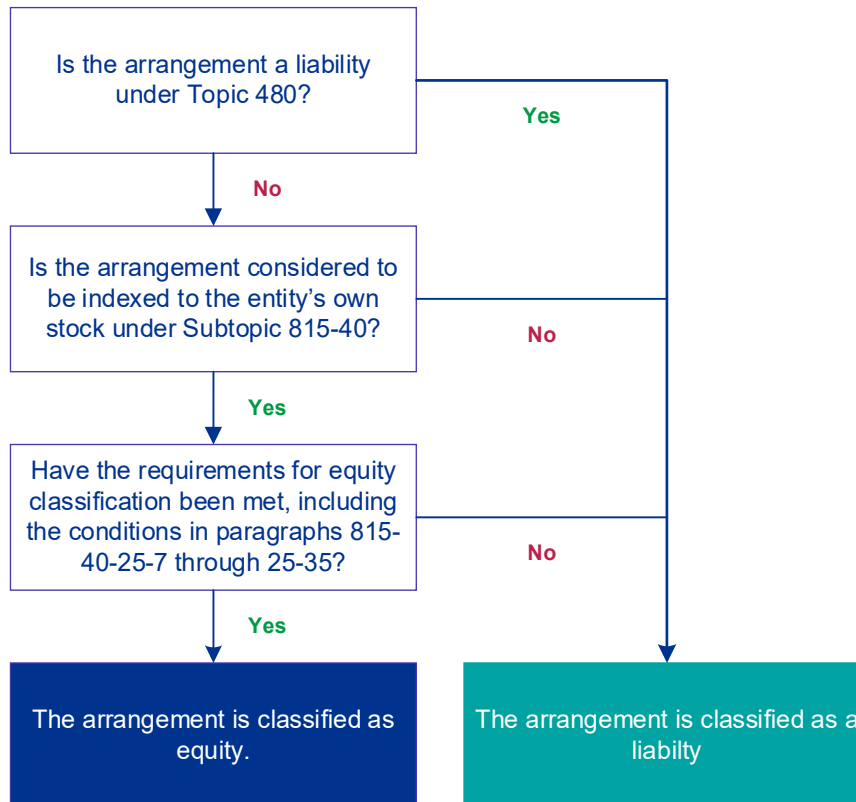


Question 6.8.10
How does an issuer determine whether to classify a contingent consideration arrangement as a liability or equity?

Interpretive response: Topic 480 and Subtopic 815-40 generally apply to financial instruments:

- for which the payoff to the counterparty is based, in whole or in part, on variations in the fair value of the issuer's own shares (or the shares of a consolidated subsidiary of the issuer); or
- that are potentially settled in the issuer's own shares (or the shares of a consolidated subsidiary of the issuer).

The first step in determining whether a contingent consideration arrangement is classified as a liability or equity requires determining whether the arrangement has either of those characteristics. If neither of those characteristics is present, the contingent consideration arrangement is a liability under Topic 805 and no further analysis of classification is necessary. However, if either of those characteristics apply to the contingent consideration arrangement, the following decision tree illustrates the process for evaluating whether to classify an obligation to pay contingent consideration as a liability or as equity under Subtopics 480-10 and 815-40:





Question 6.8.20

How are Topic 480 and Subtopic 815-40 applied to multiple contingent consideration arrangements in business combinations?

Interpretive response: Certain business combinations may contain multiple contingent consideration arrangements. In those circumstances, the guidance in Topic 480 and Subtopic 815-40, and other US GAAP applies to each arrangement individually, and the classification of each arrangement as a liability or equity may differ. [480-10-15-9 – 15-10, 35-4A]

Section 6 of KPMG Handbook, [Business combinations](#), discusses how to determine the classification of contingent consideration in a business combination and provides a detailed analysis of the interaction between Topics 480 and 805. For additional discussion about classifying contingent consideration in a business combination under Subtopic 815-40, see also section 8.2.50.

6.8.20 Share-based payment arrangements



Excerpt from ASC 480-10

> Topics and Subtopics Not within Scope

• > Share-Based Compensation

15-8 The guidance in the Distinguishing Liabilities from Equity Topic does not apply to an obligation under share-based compensation arrangements if that obligation is accounted for under Topic 718. For example, **employee stock ownership plan** shares or freestanding agreements to repurchase those shares are not within the scope of this Topic because those shares are accounted for under Subtopic 718-40 through the point of redemption. However, this Topic does apply to a freestanding financial instrument that was issued under a share-based compensation arrangement but is no longer subject to Topic 718. For example, this Topic applies to a mandatorily redeemable share issued upon a grantee's exercise of a share option. (Topic 718 provides accounting guidance for dividends on allocated shares, redemption of shares, recognition of expense, and computing earnings per share [EPS].) However, employee stock ownership plan shares that are mandatorily redeemable or freestanding agreements to repurchase those shares continue to be subject to other applicable guidance related to Subtopic 718-40.



Excerpt from ASC 718-10

> Determining Whether to Classify a Financial Instrument as a Liability or as Equity

25-7 Topic 480 excludes from its scope instruments that are accounted for under this Topic. Nevertheless, unless paragraphs 718-10-25-8 through 25-19A require otherwise, an entity shall apply the classification criteria in Section 480-10-25 and paragraphs 480-10-15-3 through 15-4 in determining whether to classify as a liability a **freestanding financial instrument** given to a grantee in a share-based payment transaction. Paragraphs 718-10-35-9 through 35-14 provide criteria for determining when instruments subject to this Topic subsequently become subject to Topic 480 or to other applicable GAAP.

25-8 In determining the classification of an instrument, an entity shall take into account the classification requirements as established by Topic 480. In addition, a **call option** written on an instrument that is not classified as a liability under those classification requirements (for example, a call option on a mandatorily redeemable share for which liability classification is not required for the specific entity under the requirements) also shall be classified as equity so long as those equity classification requirements for the entity continue to be met, unless liability classification is required under the provisions of paragraphs 718-10-25-11 through 25-12.

Topic 480 generally does not apply to obligations under share-based payment arrangements that are in the scope of Topic 718. However, Topic 718 refers to Topic 480 in certain circumstances for classification considerations for freestanding financial instruments. See also Question 6.9.10. [\[480-10-15-8\]](#)

Further, the classification of a vested share-based payment award originally granted to an employee or nonemployee continues to be classified under Topic 718 unless and until it is modified after:

- a grantee is no longer an employee; or
- a nonemployee vests in the award and is no longer providing goods or services to the entity.

After such a modification, the arrangement's classification and measurement becomes subject to the requirements of other GAAP (e.g. Topics 480 or 815) at the date of the modification, unless the modification is related to an equity restructuring, as outlined in Topic 718. [\[718-10-35-9 – 35-11\]](#)

Section 3 of KPMG Handbook, [Share-based payment](#), provides a detailed analysis of the interaction between Topics 480 and 718.



Question 6.8.30

Do the classification guidelines of Topic 480 apply to obligations accounted for under Topic 718?

Interpretive response: It depends. Obligations in the scope of the share-based payment guidance in Topic 718 are excluded from the scope of Topic 480. Under Topic 718, share-based payment awards are classified as liabilities if the underlying shares are classified as liabilities. When certain mandatorily redeemable instruments are classified as equity under Topic 480, the share-based payment awards related to those instruments are classified as equity under Topic 718, unless the other criteria for equity classification in Topic 718 are not met.

However, in general share-based payment arrangements may result in liability classification as a result of Topic 480 when the awards include:

- certain mandatory redemption features that do not meet the Topic 480 scope exception, resulting in liability classification;
- conditional or unconditional obligations to repurchase shares through the transfer of cash or other assets; and
- certain obligations to issue a variable number of shares, under which the holder does not have the same economic interests as a holder of the issued shares of the entity. [480-10-15-8, 718-10-25-8 – 25-19]

See section 3 of KPMG Handbook, [Share-based payment](#), for in-depth discussion.

6.8.30 ESOP shares



Excerpt from ASC 718-40

20 Glossary

Employee Stock Ownership Plan

An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan.

Often ESOPs require that upon exercise or upon death, retirement or the employee reaching a certain age, the shares are required to be sold back to the employer at fair value. Other ESOPs may provide employees with a put option or other redemption feature regardless of whether the shares are not readily tradable.

Topic 480 specifies that ESOP shares or freestanding agreements to repurchase those shares are not in its scope because those shares are

accounted for under Subtopic 718-40. An entity applies Subtopic 718-40 or its related guidance through the point of redemption. [480-10-15-8]

6.9 Initial and subsequent measurement

6.9.10 Overview



Excerpt from ASC 480-10

> Mandatorily Redeemable Financial Instruments

30-1 Mandatorily redeemable financial instruments shall be measured initially at **fair value**.

30-2 If a conditionally redeemable instrument becomes mandatorily redeemable, upon reclassification the **issuer** shall measure that liability initially at fair value and reduce equity by the amount of that initial measure, recognizing no gain or loss.

> Certain Physically Settled Forward Purchase Contracts

30-3 Forward contracts that require **physical settlement** by repurchase of a fixed number of the **issuer's equity shares** in exchange for cash shall be measured initially at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges.

30-4 Two ways to obtain the adjusted fair value include:

- a. Determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately
- b. Discounting the settlement amount, at the rate implicit at inception after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction.

30-5 Equity shall be reduced by an amount equal to the fair value of the shares at inception.

30-6 Cash (as that term is used in paragraph 480-10-30-3) includes foreign currency, so physically settled forward purchase contracts in exchange for foreign currency shall be measured as provided in paragraphs 480-10-30-3 through 30-5 and 480-10-35-3, then remeasured under Topic 830.

> All Other Financial Instruments

30-7 All other **financial instruments** recognized under the guidance in Section 480-10-25 shall be measured initially at fair value.

> Derivative Financial Instruments

35-1 Financial instruments within the scope of Topic 815 shall be measured subsequently as required by the provisions of that Topic.

> Certain Physically Settled Forward Purchase Contracts and Mandatorily Redeemable Financial Instruments

35-3 Forward contracts that require **physical settlement** by repurchase of a fixed number of the **issuer's equity shares** in exchange for cash and **mandatorily redeemable financial instruments** shall be measured subsequently in either of the following ways:

- a. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.
- b. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

35-4 Cash (as that term is used in the preceding paragraph) includes foreign currency, so physically settled forward purchase contracts in exchange for foreign currency shall be measured as provided in the preceding paragraph then remeasured under Topic 830.

> All Other Financial Instruments

35-5 All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured subsequently at fair value with changes in **fair value** recognized in earnings, unless either this Subtopic or another Subtopic specifies another measurement attribute.

> Presentation

45-3 Any amounts paid or to be paid to holders of the contracts discussed in paragraph 480-10-35-3 in excess of the initial measurement amount shall be reflected in interest cost.

Financial instruments accounted for under Topic 480 are initially measured at fair value with the exception of physically settled forward purchase contracts, for which the fair value is adjusted (see section 6.9.30).

The following table summarizes the initial and subsequent measurement guidance for instruments in the scope of Topic 480.

Instrument	Initial measurement	Subsequent measurement
Mandatorily redeemable instruments (see sections 6.9.20 and 6.9.40)	Fair value. [480-10-30-1]	<ul style="list-style-type: none"> — Settlement amount and date fixed. Present value of amount to be paid at settlement, accruing interest cost using rate implicit at inception. [480-10-35-3(a)] — Settlement amount or date varies. Amount of cash that would be paid under conditions
Physically settled forward contracts that obligate an issuer to purchase a fixed number of	Fair value of underlying shares at inception adjusted for any consideration or unstated rights or privileges. [480-10-30-3]	

Instrument	Initial measurement	Subsequent measurement
its equity shares for cash (see section 6.9.30)		specified in the contract if settlement occurred at the reporting date, recognizing change in that amount from the previous reporting date as interest cost. [480-10-35-3(a)]
Obligations to issue a variable number of shares for a fixed monetary amount (e.g. stock-settled debt) (see section 6.9.50)	Fair value. [480-10-30-7]	Accreted value under Topic 835 (interest).
All other instruments (see section 6.9.60)	Fair value. [480-10-30-7]	Changes in fair value recognized in earnings, unless either Topic 480 or other accounting guidance specifies another measurement attribute. [480-10-35-5]

6.9.20 Mandatorily redeemable instruments

Mandatorily redeemable instruments are initially measured at fair value. An issuer calculates the subsequent measurement at each reporting date depending on whether the settlement amount and date are fixed or variable. [480-10-30-1, 35-3(a)]

- **Settlement amount and date are fixed.** Present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.
- **Settlement amount or date varies.** Amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the change in that amount from the previous reporting date as interest cost.



Question 6.9.10

How does an issuer initially measure a conditionally redeemable instrument when it becomes mandatorily redeemable?

Interpretive response: If a conditionally redeemable instrument that is classified in equity becomes mandatorily redeemable, the issuer reclassifies it to a liability at its then fair value, and reduces equity by the same amount without recognizing a gain or loss. [480-10-30-2]



Question 6.9.20

How does an issuer measure a conditionally redeemable instrument after the condition is resolved?

Interpretive response: An instrument issued in the form of a share that is redeemable upon the occurrence or nonoccurrence of an event becomes mandatorily redeemable when the contingency is resolved. As such, the instrument is reclassified as a liability. Upon reclassification, it is measured at fair value and equity is reduced by an equal amount. No gain or loss is recognized at the date of reclassification. [480-10-30-3, 30-7, 35-3, 35-5]

The difference between the fair value and the previous carrying amount of the instrument is added to or subtracted from net earnings available to common shareholders in calculating EPS. See section 6.13 of KPMG Handbook, [Earnings per share](#).



Question 6.9.30

What comprises interest cost for a mandatorily redeemable instrument or an obligation to repurchase equity shares by transferring assets?

Interpretive response: For a mandatorily redeemable instrument or an obligation to repurchase the issuer's equity by transferring assets (see section 6.5), any amount paid or to be paid to holders in excess of the initial measurement amount is recognized as interest cost. [480-10-35-3, 45-3]

Assuming the holder of the contract is entitled to the amount and is not required contractually to remit it to the issuer, the following are included in interest cost during the life of this type of contract consistent with financial reporting for a liability.

Include in interest cost
Dividends paid or declared on the shares
Accrued but undeclared cumulative dividends
Accretion of any difference between the carrying amount and the settlement amount
Any other contractual amounts either paid, or earned, accrued and required to be paid

If applicable, the amounts attributable to changes in spot foreign currency rates (see Question 6.9.70) are recognized in earnings and classified consistent with the entity's policy for similar changes in other liabilities.



Question 6.9.40

Does an issuer accrue dividends on mandatorily redeemable convertible preferred shares before a dividend is declared?

Interpretive response: Generally, yes. An issuer accrues a dividend on mandatorily redeemable convertible preferred shares before the board of directors declares a dividend if, in the event of redemption or conversion, the holder of the preferred shares will receive cash or common shares equal to the par value of the preferred shares plus any cumulative but unpaid dividends.

Public entities accrue dividends on mandatorily redeemable preferred shares before declaration. This is based on SEC staff guidance that entities increase the carrying amount of redeemable preferred shares by periodic accretions using the effective interest method so that the carrying amount will equal the mandatory redemption amount. We believe nonpublic entities should also accrue dividends on cumulative convertible redeemable preferred shares regardless of whether the dividend is declared. [\[480-10-S99-2\]](#)

Section 3.3 of KPMG Handbook, [Earnings per share](#), discusses income available to common stockholders and preferred dividends when computing EPS.



Example 6.9.10

Preferred shares redeemable at the earlier of a fixed date or on the occurrence of certain contingent events

On January 1, Year 1, Issuer issues preferred shares with a par value of \$1 million for cash proceeds of \$600,000. The shares are mandatorily redeemable at par on the earlier of December 31, Year 5, a change in control or completion of an IPO.

The preferred shares are mandatorily redeemable instruments because they unconditionally obligate Issuer to redeem them by transferring its assets upon an event that is certain to occur. Even if there is no change in control or IPO, Issuer must redeem the preferred shares on December 31, Year 5.

Initial measurement

Issuer measures the preferred shares at their fair value (\$600,000) upon initial recognition because they are mandatorily redeemable instruments.

Subsequent measurement

Issuer subsequently measures the preferred shares based on the guidance in Topic 835 using the effective interest method. The preferred shares, in substance, represent an obligation similar to debt. Therefore, they are subsequently measured and accounted for like debt – i.e. using the effective interest method to accrete their initial carrying amount to the redemption amount based on the final redemption date of December 31, Year 5.

If the preferred shares are redeemed before the final redemption date, Issuer accounts for the difference between the shares' carrying amount and their redemption amount consistent with the accounting for an early extinguishment of debt – i.e. by recognizing the difference as an extinguishment loss in the income statement. Debt extinguishment is discussed in chapter 4.

6.9.30 Certain physically settled forward purchase contracts

Certain physically settled forward purchase contracts are accounted for under the guidance for obligations to repurchase the issuer's equity shares by transferring assets discussed in section 6.5. They are initially measured at fair value adjusted for any consideration or unstated rights and privileges.

There are two methods for determining that initial measurement.

Initial measurement methods	
Discount the settlement amount at the rate implicit in the contract after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction. [480-10-30-3 – 30-4(b)]	Determine the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately, adjusted for any consideration or unstated rights or privileges. [480-10-30-3 – 30-4(a)]

Like mandatorily redeemable instruments, how certain physically settled forward purchase contracts are subsequently measured depends on whether the settlement amount and date are fixed or variable.

Fixed or variable?	Subsequent measurement of forward contract	Recognition of interest cost
Settlement amount and date are fixed	Present value of the amount to be paid at settlement. [480-10-35-3(a)]	Accrued using the rate implicit at inception. [480-10-35-3(a)]
Settlement amount or date varies	Amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date. [480-10-35-3(b)]	Change in the carrying amount from the previous reporting date. [480-10-35-3(b)]

Physical settlement and cash delivery

The measurement guidance for physically settled forward purchase contracts applies to forward contracts that require the issuer to physically settle them by repurchasing a fixed number of its equity shares in exchange for cash. [480-10-30-3]



Question 6.9.50

How does an issuer measure a forward contract to purchase a fixed number of its equity shares that it can net-settle?

Interpretive response: A forward contract that obligates an issuer to purchase a fixed number of its equity shares that it may net-settle is in the scope of Topic 480 (see section 6.5). However, unlike physically settled forward purchase contracts that require the purchase of a fixed number of equity shares for cash, this contract is a conditional obligation that may not require the issuer to transfer cash or assets.

Settlement depends on the fair value of the contract at settlement:

- the issuer of the underlying shares will transfer assets if the fair value of the contract at the settlement date places the issuer in a loss position;
- the issuer will receive assets and will not have to transfer anything, if prices move in the issuer's favor.

Because this contract is not measured under the guidance for certain physically settled forward purchase contracts, it falls under the measurement guidance for all other instruments discussed in section 6.9.60. [480-10-30-3, 30-7, 35-3, 35-5]

If net settlement is permitted, the instrument falls outside the scope of the measurement guidance for certain physically settled forward purchase contracts regardless of the issuer's intention to physically settle or its past settlement practice. [480-10-30-3, 30-7, 35-3, 35-5]



Question 6.9.60

How does the issuer measure certain physically settled forward purchase contracts based on a fixed purchase price and a variable interest rate?

Interpretive response: There is no requirement that a fixed amount of cash (e.g. a fixed purchase price plus a fixed financing cost) be exchanged for a fixed number of shares to apply the measurement guidance for physically settled forward purchase contracts. The measurement guidance applies even if the interest included in the settlement amount is based on a variable interest rate. [480-10-30-3, 35-5]



Example 6.9.20

Physically settled forward purchase contract with a variable price

On January 1, Year 1, ABC Corp. enters into a forward contract to repurchase one million of its common shares from DEF Corp. on December 31, Year 3.

The following additional facts are relevant.

- On January 1, Year 1, the current per share price of the underlying shares is \$25.
- ABC is required to pay cash to repurchase the shares – i.e. ABC is obligated to transfer \$25 million and interest of SOFR plus 2% on December 31, Year 3, and will receive 1 million of its shares.

The forward contract is a physically settled contract that obligates ABC to purchase a fixed number (one million) of its equity shares for cash.

Initial measurement

ABC initially measures the liability at the fair value of the shares at inception of the contract. Based on the fact pattern in this example, there were no adjustments necessary for any consideration or unstated rights or privileges on January 1, Year 1.

No. shares	×	FV of shares at inception	=	Liability
1 million		\$25/share		\$25 million

ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Equity	25,000,000	
Liability		25,000,000
<i>To recognize forward purchase contract at inception.</i>		

Subsequent measurement

Because the amount to be paid at settlement varies based on SOFR, at each reporting date ABC subsequently measures the forward contract at the amount of cash that it would pay under the conditions specified in the contract if settlement occurred at the reporting date.

As a result, at each reporting date, ABC reports the liability on its balance sheet at \$25 million plus accrued interest at SOFR plus 2%. ABC also recognizes changes from the initial liability balance of \$25 million as interest cost.

At December 31, Year 1 assuming SOFR of 2% applies for the period (i.e. total interest rate is 4%), ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Interest expense ¹	1,000,000	
Liability		1,000,000
<i>To recognize changes to carrying amount of forward purchase contract at reporting date.</i>		
Note:		
1. \$25 million × 4%.		



Question 6.9.70

How does the issuer measure physically settled forward purchase contracts settled in a foreign currency?

Interpretive response: Physically settled forward purchase contracts settled in a foreign currency still meet both measurement requirements: physical settlement and cash delivery. Therefore, physically settled forward purchase contracts in exchange for foreign currency are measured under the guidance for physically settled forward purchase contracts. [480-10-30-4]

Further, the feature embedded in the contract requiring settlement in a currency different from the issuer’s functional currency is not analyzed under Topic 815’s embedded derivative guidance. The embedded feature meets the foreign currency exception in Topic 815 and the liability is remeasured to spot exchange rates under Topic 830 (foreign currency). [480-10-30-4, 815-15-15-5, 15-6, 15-14]

See KPMG Handbook, [Derivatives and hedging](#), for guidance about accounting for embedded derivatives.



Example 6.9.30

Physically settled forward purchase contract with a fixed price and an exchange of cash at inception

On January 1, Year 1, ABC Corp. enters into a forward contract to repurchase one million of its equity shares from DEF Corp. on December 31, Year 3.

The following additional facts are relevant.

- On January 1, Year 1, the current per share price of the underlying shares is \$20.
 - On January 1, Year 1, DEF pays \$5 million cash to ABC.
 - ABC is required to pay \$30 million to repurchase the equity shares – i.e. ABC is obligated to transfer \$30 million on December 31, Year 3 and will receive one million of its equity shares.
- The forward contract is a physically settled contract that obligates ABC to purchase a fixed number (one million) of its equity shares for cash.

Initial measurement

ABC initially measures the liability at the fair value of the shares at inception of the contract, adjusted for any consideration or unstated rights or privileges on January 1, Year 1.

No. shares		FV of shares at inception		Consideration		Liability
1 million	×	\$20/share	+	\$5 million	=	\$25 million

ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	5,000,000	
Equity	20,000,000	
Liability		25,000,000
<i>To recognize consideration received and FV of liability at inception, adjusted for consideration.</i>		

Subsequent measurement

The forward contract provides a fixed settlement amount and settlement date. At each reporting date, ABC measures the liability at the present value of the amount it would pay at settlement.

ABC accrues interest cost using the rate implicit at inception (after adjustment for any consideration or unstated rights or privileges). The rate implicit at inception of the contract is 9.54% – the rate that equates to a payment of \$30 million in two years for an initial \$25 million liability.



Question 6.9.80

Why aren't all obligations to repurchase the issuer's equity shares under Topic 480 initially measured at fair value?

Interpretive response: Financial instruments in the scope of Topic 480 are initially measured at fair value with the exception of physically settled forward purchase contracts that require an issuer to purchase a fixed number of its equity shares for cash.

An unconditional obligation arising from a forward contract requiring the issuer to transfer cash and the holder to deliver equity shares is like a treasury share purchase under Subtopic 505-30 using borrowed funds. The contract effectively converts the shares that the counterparty is required to deliver into mandatorily redeemable instruments, which Topic 480 classifies as liabilities. Under Subtopic 505-30, a treasury share purchase is initially measured at fair value, adjusted for any consideration or unstated rights or privileges. Therefore, the amount representing the fair value of the equity shares repurchased is accounted for as the cost of the shares acquired. [FAS 150.B61]

In contrast, contracts to repurchase the issuer's equity shares that are conditional obligations – e.g. forward purchase contracts that must be net-cash or net-share settled, or written options – are not like treasury stock purchases using borrowed funds. In these circumstances, the issuer would be required to transfer assets only if it is in a loss position. As a result, contracts to repurchase the issuer's equity shares that are conditional obligations are measured differently from physically settled forward contracts to buy the issuer's equity shares. [480-10-30-1, 30-3, 505-30-30-3, 835-30-25-6]



Question 6.9.90

Why is subsequent measurement the same for mandatorily redeemable instruments and physically settled forward purchase contracts?

Interpretive response: Mandatorily redeemable instruments and physically settled forward purchase contracts embody unconditional obligations to transfer cash. Because both instruments are liabilities that require cash payment, these instruments are subsequently measured at the present value of the full repurchase price when amounts to be paid and settlement date are fixed. When either the amount to be paid or the settlement date varies based on specified conditions, they are measured at the undiscounted amounts that would be paid under the contract if it were settled at the reporting date. These are common ways to measure fixed- and floating- rate borrowings. [480-10-35-3, FAS 150.B27, B61, B63]

FASB examples

The FASB has provided two examples of physically settled forward contracts that obligate an issuer to purchase a fixed number of its equity shares for cash.



Excerpt from ASC 480-10

• • > Physically Settled Forward Purchase Contract

55-14 For example, an entity may enter into a forward contract to repurchase 1 million shares of its common stock from another party 2 years later. At inception, the forward contract price per share is \$30, and the current price of the underlying shares is \$25. The contract's terms require that the entity pay cash to repurchase the shares (the entity is obligated to transfer \$30 million in 2 years). Because the instrument embodies an unconditional obligation to transfer assets, it is a liability under paragraphs 480-10-25-8 through 25-12. The entity would recognize a liability and reduce equity by \$25 million (which is the present value, at the 9.54 percent rate implicit in the contract, of the \$30 million contract amount, and also, in this example, the fair value of the underlying shares at inception). Interest would be accrued over the 2-year period to the forward contract amount of \$30 million, using the 9.54 percent rate implicit in the contract. If the underlying shares are expected to pay dividends before the repurchase date and that fact is reflected in the rate implicit in the contract, the present value of the liability and subsequent accrual to the contract amount would reflect that implicit rate. Amounts accrued are recognized as interest cost.

55-15 In this example, no consideration or other rights or privileges changed hands at inception. If the same contract price of \$30 per share had been agreed to even though the current price of the issuer's shares was \$30, because the issuer had simultaneously sold the counterparty a product at a \$5 million discount, that right or privilege unstated in the forward purchase contract would be taken into consideration in arriving at the appropriate implied

discount rate—9.54 percent rather than 0 percent—for that contract. That entity would recognize a liability for \$25 million, reduce equity by \$30 million, and increase its revenue for the sale of the product by \$5 million. Alternatively, if the same contract price of \$30 per share had been agreed to even though the current price of the issuer's shares was only \$20, because the issuer received a \$5 million payment at inception of the contract, the issuer would recognize a liability for \$25 million and reduce equity by \$20 million. In both examples, interest would be accrued over the 2-year period using the 9.54 percent implicit rate, increasing the liability to the \$30 million contract price.

55-16 If a **variable-rate forward contract** requires physical settlement, a different measurement method is required subsequently, as set forth in paragraph 480-10-35-3.

55-17 In contrast to forward purchase contracts that require physical settlement in exchange for cash, forward purchase contracts that require or permit net cash settlement, require or permit net share settlement, or require physical settlement in exchange for specified quantities of assets other than cash are measured initially and subsequently at fair value, as provided in paragraphs 480-10-30-2, 480-10-30-7, 480-10-35-1, and 480-10-35-5 (as applicable), and classified as assets or liabilities depending on the fair value of the contracts on the reporting date.

6.9.40 Subsequent measurement and presentation when all the issuer's shares are mandatorily redeemable



Excerpt from ASC 480-10

> Presentation

45-2A Some entities have outstanding shares, all of which are subject to mandatory redemption on the occurrence of events that are certain to occur. The redemption price may be a fixed amount or may vary based on specified conditions. If all of an entity's shares are subject to mandatory redemption and the entity is not subject to the deferral in paragraphs 480-10-15-7A through 15-7F, an excess of the redemption price of the shares over the entity's equity balance shall be reported as an excess of liabilities over assets (a deficit), even though the mandatorily redeemable shares are reported as a liability. If the redemption price of the mandatorily redeemable shares is less than the book value of those shares, the entity should report the excess of that book value over the liability reported for the mandatorily redeemable shares as an excess of assets over liabilities (equity).

45-2B Depending on the settlement terms, this Subtopic requires that mandatorily redeemable shares that are not subject to the deferral in paragraphs 480-10-15-7A through 15-7F be measured at either the present value of the amount to be paid at settlement or the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount as interest cost (change in redemption amount).

For a non-SEC registrant, a mandatorily redeemable instrument is exempt from Topic 480 if it does not have a fixed redemption date or redemption amount referenced to certain indices (see section 6.4.20). However, a number of measurement issues arise for SEC registrants that have no equity instruments outstanding, but have financial instruments issued in the form of shares, all of which are mandatorily redeemable and classified as liabilities under Topic 480.



Question 6.9.100

How does an SEC registrant subsequently measure a mandatorily redeemable instrument if it has no equity instruments outstanding?

Interpretive response: The method for subsequent measurement of a mandatorily redeemable instrument in the scope of Topic 480 is the same regardless of whether the entity has any equity instruments outstanding. Section 6.9.40 discusses the subsequent measurement of a mandatorily redeemable instrument.



Question 6.9.110

Can an SEC registrant that has no equity outstanding have net income if it has issued an instrument that is mandatorily redeemable at book value at an uncertain date?

Interpretive response: No. An SEC registrant that has no equity for accounting purposes cannot have net income during the periods in which a mandatorily redeemable instrument is outstanding if:

- that instrument is redeemable for its book value at an uncertain future date – e.g. upon death of the counterparty; and
- net book value is positive at the reporting date.

In this case, the mandatorily redeemable instrument (a liability) is subsequently measured at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date. That is, the carrying amount of the liability is the book value of the entity's assets net of its other liabilities. [480-10-35-3]

The change from the previous period is recognized as interest cost (separately from other interest). Therefore, while the entity may report an amount of income before interest on mandatorily redeemable shares, the net income is always zero, provided net book value is positive. When the liability balance is adjusted, the offset is to the income statement. Because the instrument is redeemable at book value, the SEC registrant never reports net income for accounting purposes. [480-10-35-3]



Question 6.9.120

If an SEC registrant has no equity instruments outstanding, how does it present a mandatorily redeemable instrument redeemable at other than book value at an uncertain future date?

Interpretive response: It depends on whether the subsequent changes in the liability are greater or less than net income for the period or the book value of the entity. [480-10-45-2A – 45-2B]

Book value vs redemption amount of mandatorily redeemable instrument	Presentation
Book value is greater than redemption amount	Excess of the book value over the liability for the mandatorily redeemable instrument is reported as an excess of assets over liabilities on the balance sheet.
Book value is less than redemption amount	Deficit of the book value compared to the liability for the mandatorily redeemable instrument is reported as an excess of liabilities over assets on the balance sheet.

6.9.50 Obligations to issue a variable number of shares for a fixed monetary amount

An entity may have an obligation to issue a variable number of common shares for a fixed monetary amount (stock-settled debt), which is illustrated in Example 6.6.60. Stock-settled debt instruments in the scope of Topic 480 are subject to the measurement guidance in Topic 835 and are measured subsequently at accreted value – accruing interest on the settlement amount using the rate implicit at inception. [480-10-25-14, 35-1]



Example 6.9.40

Measuring stock-settled debt

On January 1, Year 1, Issuer issues a debt instrument to Holder for \$100,000. The debt instrument obligates Issuer to deliver a variable number of its common shares that have a fair value equal to \$110,000 (a fixed monetary amount) on December 31, Year 5. Therefore, the debt instrument is in the scope of Topic 480.

Initial measurement

Stock-settled debt instruments are in the scope of the guidance for certain obligations to issue a variable number of shares. Issuer initially measures the debt instrument at fair value (\$100,000) because it is in the scope of Topic 480.

Subsequent measurement

Stock-settled debt instruments in the scope of the guidance for certain obligations to issue a variable number of shares are subsequently measured at their accreted value under Topic 835. Issuer subsequently measures the debt instrument at its accreted value under Topic 835 at the present value of the \$110,000 settlement amount, accruing interest cost using the rate implicit at inception.

Although the obligation will be settled by issuing common shares, the debt instrument is subject to the guidance in Topic 835.

6.9.60 All other instruments

Generally, an instrument in the scope of Topic 480 that is neither a:

- mandatorily redeemable instrument; nor
- physically settled forward contract that obligates an issuer to purchase a fixed number of its equity shares for cash,

is initially measured at fair value and subsequently remeasured to fair value each period with changes recognized in earnings. [480-10-30-7, 35-5]



Question 6.9.130

How does an issuer measure a forward contract to purchase a fixed number of its equity shares that will settle by delivery of an asset other than cash?

Interpretive response: A forward contract that obligates an issuer to purchase a fixed number of its number of shares in exchange for an asset other than cash (e.g. government securities) is a barter contract and is initially measured at fair value. Subsequently, it is remeasured to fair value and the changes in fair value are recognized in earnings. [480-10-30-3, 30-7, 35-3, 35-5]

There are specific measurement requirements in Topic 480 for mandatorily redeemable instruments and physically settled forward contracts that obligate an issuer to purchase a fixed number of its equity shares for cash (not cash equivalents). All other instruments in the scope of Topic 480, including a forward purchase contract on an entity's equity shares that settles by delivery of cash equivalents (e.g. government securities) are initially measured at fair value and subsequently remeasured to fair value each period with changes in fair value recognized as interest cost. [480-10-30-3, 30-7, 35-3, 35-5]

6.10 Analysis of certain complex instruments under Topic 480

Some financial instruments permit settlement alternatives or comprise multiple components that can make it difficult to determine whether the instrument is in the scope of Topic 480 and, if so, which classification guidance to follow.

This section reviews concepts already covered throughout chapter 6 for more complex financial instruments and how to determine whether they are in the scope of Topic 480, including:

- outstanding shares that embody an obligation with settlement alternatives;
- financial instruments that are not outstanding shares that embody an obligation with settlement alternatives;
- compound financial instruments; and
- share repurchase programs.

6.10.10 Analyzing outstanding shares that embody an obligation with settlement alternatives

Financial instruments may be in the scope of Topic 480 even when they permit the issuer or the holder to determine how the issuer will settle the obligation at the settlement date – by transferring its assets or issuing its equity shares. This section examines whether financial instruments that are outstanding shares and can be settled either by transferring assets or issuing the entity’s equity shares are in the scope of Topic 480.

See the overview diagram in section 6.1 when reviewing the recognition criteria for each instrument under Topic 480.



Example 6.10.10

Redeemable preferred shares that may be settled in cash or a variable number of the issuer’s equity shares

Scenario 1: Settlement at issuer’s option

Issuer issues preferred shares that must be redeemed 10 years from the issuance date. Issuer has the option to redeem the instrument for either:

- an amount equal to the \$100,000 liquidation preference of the shares (plus cumulative, unpaid dividends) in cash; or
- a variable number of its common equity shares with a fair value equal to that redemption amount.

Issuer determines whether the instrument is in Topic 480's scope as follows.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It could be settled in equity shares; therefore, it does not embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets.
Obligations to repurchase equity shares by transferring assets	No	It is an outstanding share.
Certain obligations to issue a variable number of shares	Yes	<ul style="list-style-type: none"> — It embodies an unconditional obligation; — Issuer may settle its obligation by issuing a variable number of its common shares; and — At inception, the monetary value of the obligation is based solely on a fixed monetary amount known at inception. Holder will receive \$100,000 plus cumulative, unpaid dividends, in either cash or a variable number of Issuer's common shares in 10 years.

As a result of the analysis, Issuer accounts for the instrument under Topic 480.

Scenario 2: Settlement at holder's option

Assuming the same facts as Scenario 1 except that the settlement option is with Holder, the conclusion remains the same under Topic 480. The instrument is accounted for under Topic 480.



Example 6.10.20

Redeemable preferred shares that may be settled in cash or a fixed number of the issuer's equity shares

Scenario 1: Settlement at issuer's option

Issuer issues preferred shares that must be redeemed 10 years from the date of issuance. Issuer has the option to redeem the instrument for an amount equal to the \$100,000 liquidation preference of the shares (plus cumulative, unpaid dividends) or 1,000 Issuer common equity shares.

Issuer determines whether the instrument is in Topic 480's scope, as follows:

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It could be settled in equity shares; therefore, it does not embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets.


Topic 480 instrument	In the scope?	Because
Obligations to repurchase equity shares by transferring assets	No	It is an outstanding share.
Certain obligations to issue a variable number of shares	No	The share settlement alternative does not require settlement by a variable number of shares – the number is fixed at 1,000 common equity shares.

The instrument is not in the scope of Topic 480.

Scenario 2: Settlement at holder’s option

Assuming the same facts as Scenario 1 except that the settlement option is with Holder, the conclusion remains the same. The instrument is not in the scope of Topic 480.

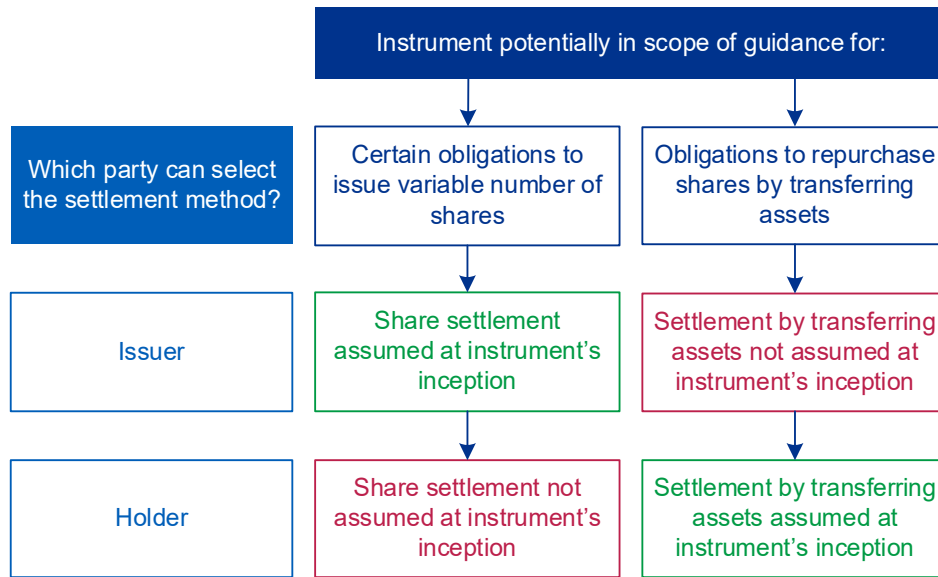
6.10.20 Analyzing instruments that are not outstanding shares that embody an obligation with settlement alternatives

 **Question 6.10.10**
How is a financial instrument that is not an outstanding share analyzed when there is more than one way it can be settled?

Interpretive response: If a financial instrument is not an outstanding share, determining whether it may fall into the scope of one of the following occurs at the instrument's inception and depends on how the instrument will be settled:

- the guidance for obligations to repurchase the issuer’s equity shares by transferring assets; or
- the guidance on certain obligations to issue a variable number of shares.

The following diagram highlights how to analyze whether an instrument that is not an outstanding share and contains settlement alternatives is in the scope of Topic 480.



Example 6.10.30

Forward purchase contract issued at the same time as equity shares

Issuer sells 1,000 of its common shares to an unrelated party (Bank) for their current market value of \$50 per share less a transaction fee. At the same time, Issuer enters into a forward purchase contract with Bank to be settled at a price of \$55 per share in one year. The forward price is equal to the initial price of the common shares (\$50) plus a fixed return of 10% for the length of time the forward is outstanding.

Issuer can settle the forward at its discretion in a number of ways as follows (all settlement options are economically equivalent to Issuer).

- **Physical settlement.** The forward is settled by Bank returning the 1,000 shares to Issuer in exchange for \$55,000 ($\$55 \times 1,000$ shares).
- **Net-share settlement.** Depending on the market value of the shares on the settlement date, the forward is settled by delivery of additional shares to Bank or return of shares to Issuer so that the net return to Bank is equal to \$5,000: $(\$55 - \$50) \times 1,000$.
- **Net-cash settlement.** Depending on the market value of the shares on the settlement date, the forward is settled by the payment to or receipt of cash from Bank so that the net return to Bank is equal to \$5,000: $(\$55 - \$50) \times 1,000$.

Bank assumes the risks and rewards of ownership of the shares and is free to sell or pledge the shares. Further, because Issuer is not required to physically settle, the shares could remain outstanding after the forward contract matures.

Issuer determines whether the forward purchase contract is in Topic 480's scope, as follows.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It could be settled in equity shares; therefore, it does not embody an unconditional obligation requiring Issuer to redeem the instrument by transferring its assets.
Obligations to repurchase equity shares by transferring assets	No	Issuer can avoid transferring assets at settlement. Therefore, it is assumed Issuer will settle the instrument by transferring shares.
Certain obligations to issue a variable number of shares	Yes	<ul style="list-style-type: none"> — It is not an outstanding equity share; instead, it is a forward contract; — It embodies a conditional obligation; and — It permits Issuer to settle the conditional obligation by delivering a fixed amount known at inception.

Topic 480 requires that a freestanding forward purchase contract for the issuer's equity shares, such as the forward purchase contract in this example, be classified as a liability, regardless of the form of settlement. [480-10-25-4 – 25-6, 25-8 – 25-10, 25-12, 25-14].



Example 6.10.40

Forward purchase contract that may be settled in cash or a variable number of the issuer's equity shares

Scenario 1: Settlement at issuer's option

On March 1, Year 1, ABC Corp. enters into a forward contract to purchase its own equity shares on March 1, Year 2. The terms of the contract require settlement as follows based on the March 1, Year 2 price of ABC's common shares.

- Price is greater than \$20: ABC will, at its option, receive from the holder 50 times the amount above \$20 either in cash or a variable number of ABC equity shares with a fair value equal to 50 times the amount above \$20.
- Price less than \$20: ABC will, at its option, pay the holder 50 times the amount below \$20 either in cash or a variable number of ABC shares with a fair value equal to 50 times the amount below \$20.

ABC determines whether the instrument is Topic 480's scope, as follows.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not an outstanding share.
Obligations to repurchase equity shares by transferring assets	No	ABC can avoid transferring assets at settlement. Therefore, it is assumed ABC will settle the instrument by transferring shares.
Certain obligations to issue a variable number of shares	Yes	<ul style="list-style-type: none"> — It is not an outstanding equity share; instead, it is a forward contract; — It embodies a conditional obligation; — It permits ABC to settle the conditional obligation by delivering a variable number of its common shares; and — It has a monetary value at inception that is based solely on variations inversely related to changes in the fair value of its common shares – if ABC's common share price is less than \$20, ABC is required to transfer a variable number of its shares.

The instrument is in the scope of Topic 480 under the guidance for certain obligations to issue a variable number of shares.

Scenario 2: Settlement at holder's option

Assume the same facts as Scenario 1, except that the settlement option is with the holder.

ABC determines whether the instrument is in Topic 480's scope, as follows.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not an outstanding share.
Obligations to repurchase equity shares by transferring assets	Yes	<ul style="list-style-type: none"> — It is not an outstanding share; instead, it is a forward contract; — It embodies a conditional obligation, at inception, that is indexed to an obligation so that ABC must repurchase its own shares; and — It may require ABC to settle the obligation by transferring its assets – i.e. if ABC's common share price is less than \$20, ABC is required to transfer cash.

Topic 480 instrument	In the scope?	Because
Certain obligations to issue a variable number of shares	No	The holder can require ABC to settle the instrument by transferring assets. Therefore, it is assumed ABC will settle the instrument by transferring assets.

The instrument is in the scope of Topic 480 under the guidance for obligations to repurchase equity shares by transferring assets.

6.10.30 Analyzing compound financial instruments

Freestanding financial instruments can comprise multiple obligations (e.g. more than one option or forward contract) that can make the analysis under Topic 480 difficult. Section 480-10-55 contains examples of several types of compound financial instruments, including:

- single financial instrument with multiple components;
- multiple freestanding financial instruments with the same counterparty; and
- single financial instrument with multiple potential settlement outcomes.

Instruments under each of these categories are analyzed in this section.

Single financial instrument with multiple components



Excerpt from ASC 480-10

•• > Puttable Warrant that May Require Cash Settlement

55-31 Entity A issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of \$10 on a specified date. The put feature allows Holder instead to put the warrant back to Entity A on that date for \$2, and to require settlement in cash. If the share price on the settlement date is greater than \$12, Holder would be expected to exercise the warrant, obligating Entity A to issue a fixed number of shares in exchange for a fixed amount of cash. That feature does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than \$12, Holder would be expected to put the warrant back to Entity A and could choose to obligate Entity A to pay \$2 in cash. That feature does result in a liability, because the financial instrument embodies an obligation that is indexed to an obligation to repurchase the issuer's shares (as the share price decreases toward \$12, the fair value of the issuer's obligation to stand ready to pay \$2 begins to increase) and may require a transfer of assets. Therefore, paragraphs 480-10-25-8 through 25-12 require Entity A to classify the instrument as a liability.

- • > Warrant for Shares that Are Puttable that May Require Cash Settlement

55-32 Entity B issues a warrant for shares that can be put back by Holder immediately after exercise of the warrant. The warrant feature allows Holder to purchase 1 equity share at a strike price of \$10 on a specified date. The put feature allows Holder to put the shares obtained by exercising the warrant back to Entity B on that date for \$12, and to require physical settlement in cash. If the share price on the settlement date is greater than \$12, Holder would be expected to exercise the warrant obligating Entity B to issue a fixed number of shares in exchange for a fixed amount of cash, and retain the shares. That feature alone does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than \$12, Holder would be expected to put the shares back to Entity B and could choose to obligate Entity B to pay \$12 in cash. That feature does result in a liability, because the financial instrument embodies an obligation to repurchase the issuer's shares and may require a transfer of assets. Therefore, those paragraphs require Entity B to classify the warrant as a liability. A warrant to issue shares that will be mandatorily redeemable is also classified as a liability, and should be analyzed under Topic 815.

- • > Freestanding Warrants and Other Similar Instruments on Shares that Are Redeemable

55-33 A warrant for puttable shares conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned on the warrant's being exercised and the shares obtained by the warrant being put back to the issuer for cash or other assets. Similarly, a warrant for mandatorily redeemable shares also conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned only on the warrant's being exercised because the shares will be redeemed. Thus, warrants for both puttable and mandatorily redeemable shares are analyzed the same way and are liabilities under paragraphs 480-10-25-8 through 25-12, even though the number of conditions leading up to the possible transfer of assets differs for those warrants. The warrants are liabilities even if the share repurchase feature is conditional on a defined contingency.

The above implementation guidance in Section 480-10-55 addresses single freestanding financial instruments with multiple components. The examples in this section illustrate that guidance. See also additional discussion in section 6.3.10 about freestanding financial instruments with multiple components. [480-10-55-29 – 55-32, 55-42 – 55-52]



Example 6.10.50

Puttable warrant and a warrant for puttable shares that each may require cash settlement and are immediately puttable

The following analysis applies to two different instruments:

- a puttable warrant on shares that may require cash settlement; and
- a warrant for shares that are puttable that may require cash settlement.

Because Topic 480 applies to instruments comprising more than one option or forward contract, each of these contracts is analyzed as a single freestanding instrument comprising a written call option and a written put option.

The instruments are not issued in the form of shares, so they are not considered mandatorily redeemable financial instruments. However, they have to be analyzed under the two remaining categories of liability-classified instruments in Topic 480.

Written call options

As shown in the table, the written call options do not cause the instruments to fall in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	They are not issued in the form of shares.
Obligations to repurchase equity shares by transferring assets	No	At inception, they do not embody obligations of the issuer to transfer assets at settlement.
Certain obligations to issue a variable number of shares	No	They embody obligations that the issuer may be required to settle by issuing a fixed, not variable, number of shares

Written put options

As shown in the table, the written put options cause the instruments to fall in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	They are not issued in the form of shares.
Obligations to repurchase equity shares by transferring assets	Yes	<ul style="list-style-type: none"> — They are not outstanding shares; instead, they are puttable warrants; — They embody obligations, at inception, that are indexed to obligations to repurchase the issuer's own shares; in this example, the put features represent conditional obligations; and — They may require the issuer to settle the obligations by transferring its assets – if the issuer's common share price is below a stated amount and the put options are exercised, the issuer is required to pay cash.

Topic 480 instrument	In the scope?	Because
Certain obligations to issue a variable number of shares	No	They do not contain obligations that the issuer may be required to settle by issuing a variable number of its equity shares.

Because the written put options are in the scope of Topic 480, the instruments are accounted for in their entirety under Topic 480.



Example 6.10.60

Warrant for puttable shares that may require cash settlement when the shares are puttable at a future date

Topic 480 also scopes in a warrant to acquire common or preferred shares that are not immediately puttable after exercise of the warrant, but that:

- will become puttable at a future date; or
- would become puttable if a contingent event that is not in the issuer's control occurs – e.g. equity shares that become puttable upon a change in control, which (as defined in the warrant) includes events that are not in the issuer's control.

It is not necessary for the exercise period of the warrant to overlap with the put date(s) on the underlying common or preferred shares for the warrant to be in the scope of Topic 480. Further, a warrant to acquire contingently puttable common or preferred shares would be in the scope of Topic 480 regardless of the probability that the contingent event will occur (provided that the contingent feature is substantive).

The FASB example of a warrant for shares that are puttable that may require cash settlement in paragraph 480-10-55-32 does not address the issue of whether shares received upon exercise of the warrant are in the scope of Topic 480. They are outside the scope of Topic 480. This is because while the instrument is issued in the form of shares, it:

- does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets;
- the put option is exercisable at the holder's discretion; and
- does not contain a specific date on which assets are required to be transferred.

The FASB example in paragraph 480-10-55-32 also clarifies that a warrant to issue equity shares that will be mandatorily redeemable should be classified as a liability and analyzed under Topic 815. [\[480-10-55-32\]](#)



Example 6.10.70 Warrant to acquire puttable shares

On January 1, Year 1, Issuer issues a warrant whereby Holder can elect to purchase a fixed number of Issuer's preferred shares for \$50 per share (a written call option) at any time for a period of five years. Physical settlement is required. Issuer's preferred shares can be put back to Issuer by Holder for \$60 per share at any time after December 31, Year 8. The put option embedded in the preferred shares is not nonsubstantive or minimal.

The contract is analyzed as a single freestanding instrument comprising a written call option and a written put option.

The instrument is not issued in the form of a share, so it is not considered a mandatorily redeemable financial instrument.

Written call option

As shown in the table, the written call option does not cause the instrument to fall in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share.
Obligations to repurchase equity shares by transferring assets	No	Issuer could not be required to transfer assets at settlement; instead, it would issue a fixed number of preferred shares if the call option is exercised.
Certain obligations to issue a variable number of shares	No	It embodies an obligation that Issuer may be required to settle by issuing a fixed number of preferred shares instead of a variable number of shares.

Written put option

As shown in the table, the written put option causes the instrument to fall in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share.
Obligations to repurchase equity shares by transferring assets	Yes	<ul style="list-style-type: none"> — It is not an outstanding share; instead, it is a warrant to acquire puttable shares; — It requires issuance of a financial instrument (preferred shares) with an embedded written put option that embodies an obligation, at inception,

Topic 480 instrument	In the scope?	Because
		that is indexed to an obligation to repurchase its own shares; in this example, the put feature represents a conditional obligation; and — It may require Issuer to settle the obligation by transferring its assets – if the written call option is exercised, Issuer would issue preferred shares that the holder may ultimately put back to Issuer for cash after December 31, Year 8. It is not necessary for the exercise period of the warrant (January 1, Year 1 to December 31, Year 5) to overlap with the put dates on the underlying preferred shares (any time after December 31, Year 8) for the warrant to be in the scope of Topic 480.
Certain obligations to issue a variable number of shares	No	It does not contain an obligation that Issuer may be required to settle by issuing a variable number of its equity shares.

Because the written put option (embedded in the preferred shares underlying the warrant) are in the scope of Topic 480, the instruments are accounted for in their entirety under Topic 480.

Upon exercise of the warrant, Issuer’s preferred shares (which contain an embedded put option) would not be in the scope of Topic 480.

 **Example 6.10.80**
Warrant to acquire contingently puttable shares

On January 1, Year 1, Issuer issues a warrant whereby Holder can elect to purchase a fixed number of Issuer’s common shares for \$50 per share (a written call option) at any time for a period of five years. Physical settlement is required. Issuer’s common shares can be put back to Issuer by Holder for \$60 per share upon a ‘change in control,’ which as defined includes events that are not in Issuer’s control.

The contract is analyzed as a single freestanding instrument comprising a written call option and a written put option.

Although the occurrence of a change in control is not considered likely at the present time, the contingent put option embedded in the common shares is not deemed nonsubstantive or minimal and is considered in the analysis of the written put option.

The instrument is not issued in the form of shares, so it is not considered a mandatorily redeemable financial instrument. [\[480-10-25-4, 25-6\]](#)

Written call option

As shown in the table, the written call option does not cause the instrument to fall in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share.
Obligations to repurchase equity shares by transferring assets	No	Issuer could not be required to transfer assets at settlement; instead, it would issue a fixed number of common shares if the written call option is exercised
Certain obligations to issue a variable number of shares	No	It embodies an obligation that Issuer may be required to settle by issuing a fixed number of common shares, instead of a variable number of shares.

Written put option

As shown in the table, the written put option causes the instrument to fall in the scope of Topic 480, even though it is contingent.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share.
Obligations to repurchase equity shares by transferring assets	Yes	<ul style="list-style-type: none"> — It is not an outstanding share; instead, it is a warrant to acquire contingently puttable shares. — It requires issuance of a financial instrument (common shares) with an embedded contingent written put option that embodies an obligation, at inception, that is indexed to an obligation to repurchase its own shares; in this example, the contingent put feature represents a conditional obligation. — It may require Issuer to settle the obligation by transferring its assets – if the written call option is exercised, Issuer would issue common shares that the holder may ultimately put back to Issuer for cash if a change in control occurs. The warrant in its entirety is in the scope of Topic 480, regardless of the probability that the contingent event enabling the holder to put the underlying shares back to Issuer will occur.

Topic 480 instrument	In the scope?	Because
Certain obligations to issue a variable number of shares	No	It does not contain an obligation that Issuer may be required to settle by issuing a variable number of its equity shares.

Because the contingent written put option (embedded in the common shares underlying the warrant) is in the scope of Topic 480, the instruments is accounted for in its entirety under Topic 480.

Upon exercise of the warrant, Issuer's common shares (which contain an embedded contingent put option) would not be in the scope of Topic 480.



Example 6.10.90

Warrants exercisable for puttable preferred shares terminated in exchange for a different class of equity-classified preferred shares

Issuer issues warrants (Series X warrants) to Holder that are exercisable for Series X puttable preferred shares.

At a later date, Issuer issues Series Y preferred shares to Holder in exchange for cash and the termination of the Series X warrants.

Initial measurement

Under the guidance for freestanding warrants on shares that are redeemable, Issuer classifies the Series X warrants as liabilities under Topic 480, and initially and subsequently measures them at fair value. [480-10-30-3, 35-5, 55-33]

Issuer initially measures the Series Y preferred shares at fair value determined as the cash received plus the fair value of the warrants at the time they were extinguished.

On termination of the warrants

Because the Series X warrants were measured at fair value at the time they were extinguished, Issuer recognizes the reversal of the liability in equity as part of the initial recorded amount of the Series Y preferred shares. [480-10-35-5]

Three freestanding financial instruments with the same counterparty



Excerpt from ASC 480-10

- • > Three Freestanding Instruments

55-34 An issuer has the following three freestanding instruments with the same counterparty, entered into contemporaneously:

- a. A written put option on its equity shares
- b. A purchased call option on its equity shares
- c. Outstanding shares of stock.

55-35 Under this Subtopic those three contracts would be separately evaluated. The written put option is reported as a liability under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement) and is measured at fair value. The purchased call option does not embody an obligation and, therefore, is not within the scope of this Subtopic. The outstanding shares of stock also are not within the scope of this Subtopic, because the shares do not embody an obligation for the issuer. Under paragraph 480-10-25-15, neither the purchased call option nor the shares of stock are to be combined with the written put option in applying paragraphs 480-10-25-4 through 25-14 unless otherwise required by Topic 815. If that Topic required the freestanding written put option and purchased call option to be combined and viewed as a unit, the unit would be accounted for as a combination of options, following the guidance in paragraphs 480-10-55-18 through 55-20.



Example 6.10.100

Multiple freestanding instruments with the same counterparty (1)

Issuer issues three instruments to the same counterparty:

- a written put option on its equity shares;
- a purchased call option on its equity shares; and
- outstanding common shares.

The following is relevant to the written put option and purchased call option:

- each requires physical settlement;
- each has a term of five years; and
- each is exercisable only at expiration.

Are the options freestanding financial instruments?

Separate and apart from criterion

Although the put option, call option and common shares are in separate documents, they are issued concurrently to the same counterparty. Therefore, the criterion is met.

Legally detachable and separately exercisable criterion

The put option, call option and common shares are in separate contracts and require physical settlement. Neither party is required to deliver specifically identified equity shares to the other party. Therefore, the put option and call option are considered legally detachable and separately exercisable because the specific common shares the holder has may continue to exist unchanged if the holder exercises the put option or if Issuer exercises the call option. Further, because Topic 815 does not require the purchased call option or the shares to be combined with the written put option, Topic 480 indicates that they are not combined. [480-10-25-15]

As a result, Issuer considers each instrument to be freestanding. Next, Issuer determines whether to combine the instruments under Topic 480.

Are the three instruments combined under Topic 480?

No. Topic 815 does not require the purchased call option or the common shares to be combined with the written put option, and Topic 480 indicates they are not combined.

Are the three instruments each in the scope of Topic 480?

Written put option

As shown in the following table, the physically settled written put option is in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share.
Obligations to repurchase equity shares by transferring assets	Yes	<ul style="list-style-type: none"> — It is not an outstanding share of Issuer (it is an option contract); — It embodies an obligation, at inception, such that Issuer may be required to repurchase its own shares; in this example, it represents a conditional obligation that may be exercised by the holder; and — It may require Issuer to settle the obligation by transferring its assets. [480-10-25-8 – 25-10, 25-12]
Certain obligations to issue a variable number of shares	No	It does not contain an obligation that Issuer must or may settle by issuing a variable number of its equity shares.

Purchased call option

As shown in the following table, the physically settled purchased call option is not in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share and does not embody an unconditional obligation to redeem the instrument by transferring assets.
Obligations to repurchase equity shares by transferring assets	No	It does not embody an obligation to repurchase Issuer’s equity shares that may require settlement by transferring assets.

Topic 480 instrument	In the scope?	Because
Certain obligations to issue a variable number of shares	No	It does not contain an obligation that Issuer must or may settle by issuing a variable number of its equity shares.

Outstanding shares

As shown in the table, the outstanding shares are not in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	The common shares: <ul style="list-style-type: none"> — do not embody an unconditional obligation that requires Issuer to redeem the instruments by transferring assets, and — do not indicate specified or determinable date(s), or an event certain to occur, upon which Issuer's assets are required to be transferred.
Obligations to repurchase equity shares by transferring assets	No	They are outstanding shares.
Certain obligations to issue a variable number of shares	No	They do not contain an unconditional obligation for Issuer that must or may be settled by issuing a variable number of its equity shares.

Two freestanding financial instruments with the same counterparty



Excerpt from ASC 480-10

• • > Two Freestanding Instruments

55-36 An issuer has the following two freestanding instruments with the same counterparty entered into contemporaneously:

- a. A contract that combines a written put option at one strike price and a purchased call option at another strike price on its equity shares
- b. Outstanding shares of stock.

55-37 As required by paragraph 480-10-25-1, paragraphs 480-10-25-4 through 25-14 are applied to the entire freestanding instrument that comprises both a put option and a call option. Because the put option element of the contract

embodies an obligation to repurchase the issuer's equity shares, the freestanding instrument that comprises a put option and a call option is reported as a liability (or asset) under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement) and is measured at fair value. Under paragraphs 480-10-15-3 through 15-4 and 480-10-25-1, that freestanding financial instrument is within the scope of this Subtopic regardless of whether at current prices it is a net written, net purchased, or zero-cost collar option and regardless of the form of settlement. The outstanding shares of stock are not within the scope of this Subtopic and, under paragraph 480-10-25-15, are not combined with the freestanding written put and purchased call option. (Some outstanding shares of stock are within the scope of this Subtopic, for example, mandatorily redeemable shares or shares subject to a physically settled forward purchase contract in exchange for cash.)



Example 6.10.110

Multiple freestanding instruments with the same counterparty (2)

Issuer issues the following instruments to the same counterparty:

- a contract that combines a written put option at one strike price and a purchased call option at another strike price on its equity shares; and
- outstanding common shares.

The contract is a collar – i.e. a compound financial instrument comprising a purchased call option and a written put option in a single contract. A collar embodies both a right and an obligation. If the fair values of the two options (the purchased call and the written put) are equal and opposite at issuance, the financial instrument has a fair value of zero at inception (and is generally called a zero-cost collar).

For purposes of this example, these instruments are freestanding and the zero-cost collar: [\[480-10-55-36\]](#)

- requires physical settlement;
- has a term of five years; and
- is exercisable only at expiration.

This fact pattern is the same as in Example 6.10.100, except that the written put option and purchased call option are contained in one contract (i.e. the collar) instead of in two separate contracts. Therefore, the analysis applied to this example is consistent with that in Example 6.10.100.

In this example, the collar and common shares are in separate contracts, physical settlement is required, and neither party is required to deliver specifically identified equity shares to the other party. Therefore, the collar is considered legally detachable and separately exercisable because the specific common shares the holder has may continue to exist unchanged when the collar is exercised. Further, because Topic 815 does not require the option agreement to be combined with the outstanding shares, the guidance for

obligations to repurchase the issuer's common shares by transferring assets indicates that they are not combined when applying Topic 480.

As a result, each instrument is considered freestanding, and Issuer determines whether the collar and equity shares individually are in the scope of Topic 480.

Single freestanding financial instrument with multiple embedded features



Excerpt from ASC 480-10

•• > One Freestanding Instrument that Is an Outstanding Share of Stock Containing Multiple Embedded Features

55-38 An entity issues a share of stock that is not mandatorily redeemable. However, under its terms the stock is both of the following:

- a. Puttable by the holder any time after five years or upon a change in control
- b. Callable by the issuer any time after five years.

55-39 That instrument is outside the scope of this Subtopic. The instrument as a whole is not mandatorily redeemable under paragraphs 480-10-25-4 and 480-10-25-6 because of both of the following conditions:

- a. The redemption is optional (conditional).
- b. A written put option and a purchased call option issued together with the same terms differ from a forward purchase contract under this Subtopic.

55-40 That combination of embedded features does not render the stock mandatorily redeemable because the options could expire at the money, unexercised, and, thus, the redemption is not unconditional. Because the instrument as a whole is an outstanding share, it is not subject to paragraphs 480-10-25-8 through 25-12, nor, because the embedded obligation is conditional, is it subject to paragraph 480-10-25-14. As a financial instrument that is not a derivative instrument in its entirety, it is subject to analysis under Subtopic 815-15 to determine whether the issuer must account for any embedded feature separately as a derivative instrument. Because of the guidance in paragraph 480-10-25-2, paragraphs 480-10-25-4 through 25-14 shall not be applied to any embedded feature for the purposes of that analysis. In applying paragraph 815-15-25-1, the embedded written put option is evaluated under the guidance in Subtopic 815-40 and would generally be classified in equity. If so, the embedded written put option meets the criterion for exclusion in paragraph 815-10-15-74(a) and, therefore, is not separated from its host contract. If the written put option was not embedded in the share, but was issued as a freestanding instrument, it would be a liability under this Subtopic.

Implicit in the FASB's example of a freestanding instrument that is an outstanding share containing multiple embedded features is the assumption that the contract combining the shares, put option, and call option is a single freestanding financial instrument. This is because the embedded features cannot be legally detached from the shares and separately exercisable. [480-10-55-38 – 55-40]

As discussed in sections 6.3.20 and 6.3.30, an issuer reviews the instrument's components to determine whether they can be both legally detached from the instrument and separately exercised. This determines whether it is possible that the remaining financial instrument(s) would continue to exist unchanged when the other financial instrument is exercised (except for the legally detached and separately exercised feature). [480-10 Glossary]

Single financial instrument with multiple potential settlement outcomes



Excerpt from ASC 480-10

- > Certain Financial Instruments Involving Multiple Components that May Be Settled in a Variable Number of Shares

55-42 A financial instrument composed of more than one option or forward contract embodying obligations to issue shares must be analyzed to determine whether the obligations under any of its components have one of the characteristics in paragraph 480-10-25-14, and if so, whether those obligations are predominant relative to other obligations. For example, a puttable warrant that allows the holder to purchase a fixed number of the issuer's shares at a fixed price that also is puttable by the holder at a specified date for a fixed monetary amount to be paid, at the issuer's discretion, in cash or in a variable number of shares.)

55-43 The analysis can be summarized in two steps:

- a. Identify any component obligations that, if freestanding, would be liabilities under paragraph 480-10-25-14. Also identify the other component obligation(s) of the financial instrument.
- b. Assess whether the monetary value of any obligations embodied in components that, if freestanding, would be liabilities under paragraph 480-10-25-14 is (collectively) predominant over the (collective) monetary value of other component obligation(s). If so, account for the entire instrument under that paragraph. If not, the financial instrument is not in the scope of this Subtopic and other guidance applies.

55-44 In an instrument that allows the holder either to purchase a fixed number of the issuer's shares at a fixed price or to compel the issuer to reacquire the instrument at a fixed date for shares equal to a fixed monetary amount known at inception, the holder's choice will depend on the issuer's share price at the settlement date. The issuer must analyze the instrument at inception and consider all possible outcomes to judge which obligation is predominant. To do so, the issuer considers all pertinent information as applicable, which may include its current stock price and volatility, the strike price of the instrument, and any other factors. If the issuer judges the obligation to issue a variable number of shares based on a fixed monetary amount known at inception to be predominant, the instrument is a liability under paragraph 480-10-25-14. Otherwise, the instrument is not a liability under this Subtopic but is subject to other applicable guidance such as Subtopic 815-40.

- • > Warrant with Share-Settleable Puts

55-45 Entity C issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of \$10 on a specified date. The put feature allows Holder instead to put the warrant back to Entity C on that date for \$2, settleable in fractional shares. If the share price on the settlement date is greater than \$12, Holder would be expected to exercise the warrant, obligating Entity C to issue a fixed number of shares in exchange for a fixed amount of cash; the monetary value of the shares varies directly with changes in the share price above \$12. If the share price is equal to or less than \$12, Holder would be expected to put the warrant back to Entity C obligating the entity to issue a variable number of shares with a fixed monetary value, known at inception, of \$2. Thus, at inception, the number of shares that the puttable warrant obligates Entity C to issue can vary, and the financial instrument must be examined under paragraph 480-10-25-14.

55-46 The facts and circumstances should be considered in judging whether the monetary value of the obligation to issue a number of shares that varies is predominantly based on a fixed monetary amount known at inception; if so, it is a liability under paragraph 480-10-25-14(a). For example, if the following circumstances existed, they would suggest that the monetary value of the obligation to issue shares would be judged to be based predominantly on a fixed monetary amount known at inception (\$2 worth of shares), and the instrument would be classified as a liability:

- Entity C's share price is well below the \$10 exercise price of the warrant at inception of the instrument.
- The warrant has a short life.
- Entity C's stock is determined to have very low volatility.

55-47 Entity E issues a warrant to Holder allowing Holder to purchase 1 equity share at a strike price of \$10. The warrant has an embedded liquidity make-whole put that entitles Holder to receive from Entity E the net amount of any difference between the share price on the date the warrants are exercised and the sales price the holder receives when the shares are later sold. The make-whole provision is not legally detachable. Entity E can settle by issuing a variable number of shares. For example, if on the date Holder exercises the warrant, the share price is \$15 and the share price subsequently decreases to \$12 at the date Holder sells the shares, Holder would receive \$3 worth of equity shares from Entity E.

55-48 The financial instrument embodies an obligation to deliver a number of shares that varies—either a fixed number of shares under exercise of the warrant or additional shares if the share price declines after the warrant is exercised. However, unless it is judged that the possibility of having to issue a variable number of shares with a monetary value that is inversely related to the share price is predominant, the financial instrument is not in the scope of paragraph 480-10-25-14(c) and would be evaluated under Subtopic 815-40.

55-49 If exercisability of a feature into a fixed or variable number of shares is contingent on both the occurrence or nonoccurrence of a specified event and the issuer's share price, a financial instrument settleable in a number of shares that can vary should be analyzed following the same method as for the examples in paragraphs 480-10-55-45 and 480-10-55-50 to consider all possibilities. In some cases, it may be determined that the instrument may not

be within the scope of paragraph 480-10-25-14 and thus not a liability under this Subtopic. That determination depends on whether the obligation to deliver a variable number of shares, with a monetary value based on either a fixed monetary amount known at inception or an inverse relationship with the share price, is predominant at inception.



Example 6.10.120

Puttable warrant that may be net-share settled

Issuer issues a warrant with a share-settleable put. The instrument is analyzed as a single freestanding instrument consisting of a written call option and a written put option. [480-10-55-45 – 55-46]

Written call option

As shown in the table, the written call option is not in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share.
Obligations to repurchase equity shares by transferring assets	No	It could not require Issuer to transfer assets at settlement. Issuer would issue a fixed number of shares in exchange for a fixed amount of cash if the written call option is exercised.
Certain obligations to issue a variable number of shares	No	It embodies an obligation that Issuer may be required to settle by issuing a fixed number of shares, instead of a variable number of shares.

Written put option

As shown in the table, the written put option is in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share.
Obligations to repurchase equity shares by transferring assets	No	It could not require Issuer to transfer assets at settlement. Issuer would issue a variable number of shares with a fixed monetary value if the written put option is exercised.
Certain obligations to issue a variable	Yes	— It embodies a conditional obligation and is not an outstanding share of Issuer (it is a puttable warrant);

Topic 480 instrument	In the scope?	Because
number of shares		<ul style="list-style-type: none"> — It permits Issuer to settle the obligation by delivering a variable number of its shares; and — It has a monetary value, at inception that is based solely on a fixed monetary amount known at inception.

The instrument is classified as a liability under the guidance for certain obligations to issue a variable number of shares if the monetary value of the net-share settled written put option component is predominant over the monetary value of the remaining component obligation (the written call option). The analysis requires Issuer to consider all possible outcomes based on all pertinent information, including its current share price, volatility, exercise price and option term. [\[480-10-55-63\]](#)



Excerpt from ASC 480-10

• • > Variable Share Forward Sales Contract

55-50 Entity D enters into a contract to issue shares of Entity D's stock to Counterparty in exchange for \$50 on a specified date. If Entity D's share price is equal to or less than \$50 on the settlement date, Entity D will issue 1 share to Counterparty. If the share price is greater than \$50 but equal to or less than \$60, Entity D will issue \$50 worth of fractional shares to Counterparty. Finally, if the share price is greater than \$60, Entity D will issue .833 shares. At inception, the share price is \$49. Entity D has an obligation to issue a number of shares that can vary; therefore, paragraph 480-10-25-14 may apply. However, unless it is determined that the monetary value of the obligation to issue a variable number of shares is predominantly based on a fixed monetary amount known at inception (as it is in the \$50 to \$60 share price range), the financial instrument is not in the scope of this Subtopic.

55-51 Some financial instruments that are composed of more than one option or forward contract embody an obligation to issue a fixed number of shares and, once those shares are issued, potentially to issue a variable number of additional shares. The issuer must analyze that kind of financial instrument, at inception, to assess whether the possibility of issuing a variable number of shares in which the monetary value of that obligation meets one of the conditions in paragraph 480-10-25-14 is predominant.



Example 6.10.130

Combined written put option and purchased call option that requires net-share settlement

ABC Corp. enters into a single contract, which, in its entirety, is a freestanding financial instrument.

- ABC can elect to purchase shares of its own stock from DEF Corp. for \$51 on a specified date if its share price exceeds \$51 (a purchased call option); and
- DEF can require ABC to purchase ABC shares on a specified date for \$50 if the share price falls below \$50 (a written put option).
- Net-share settlement is required.

Because Topic 480 applies to an instrument comprising more than one option or forward contract, the contract is analyzed as a single freestanding instrument consisting of a purchased call option and a written put option. That is, the contract is not analyzed as a forward purchase contract. [480-10-55-50 – 55-51]

Purchased call option

ABC's ability to repurchase its own shares from DEF if the price exceeds \$51 does not embody an obligation and is outside the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share.
Obligations to repurchase equity shares by transferring assets	No	It could not require ABC to transfer assets at settlement.
Certain obligations to issue a variable number of shares	No	It embodies an obligation that ABC may be required to settle by issuing a fixed number of shares, instead of a variable number of shares.

Written put option

As shown in the following table, the instrument is in the scope of Topic 480.

Topic 480 instrument	In the scope?	Because
Mandatorily redeemable financial instrument	No	It is not issued in the form of a share.
Obligations to repurchase equity shares by transferring assets	No	It could not require ABC to transfer assets at settlement. ABC would issue a variable number of shares with a fixed monetary value if the written put option is exercised.
Certain obligations to issue a variable	Yes	— It embodies a conditional obligation and is not an outstanding share of ABC (it is a puttable warrant);

Topic 480 instrument	In the scope?	Because
number of shares		<ul style="list-style-type: none"> — It may require ABC to settle the obligation by delivering a variable number of its shares; and — It has a monetary value, at inception, that is based solely on variations inversely related to changes in the fair value of the shares – if the put option is exercised and ABC's share price is less than \$50 per share, ABC is required to transfer a variable number of its shares.

6.10.40 Analyzing accelerated share repurchase programs

ASR programs are in the scope of Topic 505 (see section 5.8.60) and Subtopic 815-40 (see section 8.4.40).

If a share repurchase program differs from the ASR programs discussed in chapters 5 and 8, elements of the program may be in the scope of Topic 480 – either a transaction in the program or one of the program’s components. The following examples illustrate how to analyze these types of programs under Topic 480.



Example 6.10.140 Share repurchase program (1)

On January 1, Year 1, ABC Corp. enters into a forward contract to purchase its own equity shares on April 1, Year 1. The terms of the contract require ABC to pay \$50 million cash to the counterparty in exchange for 1 million equity shares (i.e. \$50 per share) on April 1, Year 1.

ABC simultaneously enters into a net-settled forward sale contract with the same counterparty on 1 million of ABC’s equity shares. The settlement date of this forward sale contract is also April 1, Year 1, and the settlement terms are as follows.

- If the volume-weighted average daily market price of ABC's equity shares during the contract period (January 1 to April 1, Year 1) exceeds \$50, ABC will deliver to the counterparty cash or equity shares (at ABC's option) equal to the price difference multiplied by 1 million;
- If the volume-weighted average daily market price of ABC's equity shares during the contract period is less than the \$50 initial purchase price, the counterparty will deliver to ABC cash equal to the price difference multiplied by 1 million.

Topic 815 and its related guidance does not require ABC to combine the instruments, and ABC accounts for the forward purchase contract and the forward sale contract as two separate financial instruments.

Forward purchase contract

Because the forward purchase contract requires physical settlement by repurchase of a fixed number of ABC's common shares in exchange for cash, it is evaluated under the guidance for obligations to repurchase the issuer's equity shares by transferring assets.

Characteristic of the instrument	Criterion met?
Not an outstanding share	✓
Embodies an obligation, at inception, requiring ABC to repurchase its own shares	✓
Requires ABC to settle by transferring assets	✓

Based on the terms of the forward purchase contract, it is in the scope of the guidance for obligations to repurchase the issuer's equity shares by transferring assets and is measured under the guidance in Topic 480 for certain physically settled forward purchase contracts.

Forward sale contract

The forward sale contract requires ABC to transfer its assets or a variable number of its equity shares or receive cash from the counterparty in settlement of the contract, depending on the volume-weighted average daily market price of ABC's equity shares during the contract period. In essence, the contract is a conditional obligation for ABC.

Because the instrument is not an outstanding share and ABC is entitled to determine the settlement method, the obligation is evaluated under the guidance for certain obligations to issue a variable number of shares.

Characteristic of the instrument	Criterion met?
Freestanding	✓
Unconditional obligation	✓
Requires ABC to settle by issuing variable number of common shares	✓
Monetary value based on fixed amount known at inception; variation in something other than the fair value of ABC's equity; or variations inversely related to FV changes in equity shares.	✗

The contract is outside the scope of the guidance for certain obligations to issue a variable number of shares because the monetary value, at inception, is based solely on variations directly related to changes in the fair value of ABC's common shares (the volume-weighted average daily market price of ABC's equity shares). Therefore, the contract is outside the scope of Topic 480. [480-10-25-1]



Example 6.10.150 Share repurchase program (2)

On January 1, Year 1, ABC enters into a forward contract to purchase its own equity shares on April 1, Year 1. The terms of the contract require ABC to pay \$50 million cash to the counterparty on January 1, Year 1 (inception) in exchange for 1 million of its own equity shares to be delivered on April 1, Year 1 (maturity).

ABC simultaneously enters into a net-settled forward sale contract with the counterparty on 1 million of its own equity shares. The settlement date of this forward sale contract is also April 1, Year 1, and the settlement terms are as follows.

- If the volume-weighted average daily market price of ABC's common shares during the contract period (January 1 to April 1, Year 1) exceeds the \$50 initial purchase price, ABC will deliver to the counterparty cash or equity shares (at ABC's option) equal to the price difference multiplied by 1 million.
- If the volume-weighted average daily market price of ABC's equity shares during the contract period is less than the \$50 initial purchase price, the holder will deliver to ABC cash equal to the price difference multiplied by 1 million.

Topic 815 and its related guidance does not require ABC to combine the instruments, and ABC accounts for the forward purchase contract and the forward sale contract as two separate financial instruments.

Prepaid forward purchase contract

ABC does not have a conditional or unconditional obligation to transfer assets or issue equity shares because the assets have already been transferred at inception and at maturity the entity will receive its common shares. Therefore, the physically settled prepaid forward contract to purchase a fixed number of the issuer's equity shares does not embody an obligation, which is a threshold requirement under Topic 480 (see section 6.2.10). Therefore, the contract is outside the Topic's scope. [480-10-25-8 – 25-10, 25-12, 25-14]

Forward sale contract

The forward sale contract requires ABC to transfer its assets or a variable number of its equity shares or receive cash from the counterparty in settlement of the contract, depending on the volume-weighted average daily market price of ABC's equity shares during the contract period. Because the contract is a conditional obligation (but not an outstanding share) and ABC is entitled to determine the settlement method, the obligation must be evaluated under the guidance for certain obligations to issue a variable number of shares. [480-10-25-14]

Characteristic of the instrument	Criterion met?
Freestanding	✓
Unconditional obligation or a conditional obligation (not an outstanding share)	✓

Characteristic of the instrument	Criterion met?
Requires ABC to settle by issuing variable number of common shares	✓
Monetary value based on fixed amount known at inception; variation in something other than fair value of ABC's equity; or variations inversely related to FV changes in equity shares	✗

The contract is outside the scope of the guidance for certain obligations to issue a variable number of shares because the monetary value, at inception, is based solely on variations directly related to changes in the fair value of ABC's common shares (the volume-weighted average daily market price of ABC's equity shares). Therefore, the contract is outside the scope of Topic 480.

6.10.50 Additional comprehensive FASB examples

The following excerpts from Topic 480 illustrate how NCI are comprehensively analyzed to determine whether they fall under one of the three categories of liability-classified instruments under Topic 480.



Excerpt from ASC 480-10

> Instruments

15-5 Because paragraph 480-10-15-3 limits the scope of this Topic to freestanding instruments, this Topic does not apply to a feature embedded in a **financial instrument** that is not a derivative instrument in its entirety.

- > Majority Owner's Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Instrument Indexed to the Noncontrolling Interest in That Subsidiary

55-53 A controlling majority owner (**parent**) holds 80 percent of a **subsidiary's** equity shares. The remaining 20 percent (the noncontrolling interest) is owned by an unrelated entity (the noncontrolling interest holder). Simultaneous with the acquisition of the noncontrolling interest, the noncontrolling interest holder and the parent enter into a derivative instrument that is indexed to the subsidiary's equity shares. The terms of the derivative instrument may be any of the following:

- The parent has a fixed-price forward contract to buy the other 20 percent at a stated future date. (Derivative 1)
- The parent has a call option to buy the other 20 percent at a fixed price at a stated future date, and the noncontrolling interest holder has a put option to sell the other 20 percent to the parent under those same terms, that is, the fixed price of the call is equal to the fixed price of the put option. (Derivative 2)
- The parent and the noncontrolling interest holder enter into a total return swap. The parent will pay to the counterparty (initially the noncontrolling interest holder) an amount computed based on the London Interbank Offered Rate (LIBOR), plus an agreed spread, plus, at the termination date,

any net depreciation of the fair value of the 20 percent interest since inception of the swap. The counterparty will pay to the parent an amount equal to dividends paid on the 20 percent interest and, at the termination date, any net appreciation of the fair value of the 20 percent interest since inception of the swap. At the termination date, the net change in the fair value of the 20 percent interest may be determined through an appraisal or the sale of the stock. (Derivative 3)

55-54 If the terms correspond with Derivative 1, the forward purchase contract that requires physical settlement by repurchase of a fixed number of shares (the noncontrolling interest) in exchange for cash is recognized as a liability, initially measured at the present value of the contract amount; the noncontrolling interest is correspondingly reduced. Subsequently, accrual to the contract amount and any amounts paid or to be paid to holders of those contracts are reflected as interest cost. In effect, the parent accounts for the transaction as a financing of the noncontrolling interest and, consequently, consolidates 100 percent of the subsidiary.

55-55 Depending on how Derivative 2 was issued, one of three different accounting methods applies. If Derivative 2 was issued as a single freestanding instrument, under this Subtopic it would be accounted for in its entirety as a liability (or an asset in some circumstances), initially and subsequently measured at fair value. If the written put option and the purchased call option in Derivative 2 were issued as freestanding instruments, the written put option would be accounted for under this Subtopic as a liability measured at fair value, and the purchased call option would be accounted for under Subtopic 815-40. Under both of those situations, the noncontrolling interest is accounted for separately from the derivative instrument under applicable guidance. However, if the written put option and purchased call option are embedded in the shares (noncontrolling interest) and the shares are not otherwise classified as liabilities under the guidance in this Subtopic, the instrument shall be accounted for as discussed in paragraph 480-10-55-59 with the parent consolidating 100 percent of the subsidiary.

55-56 If the terms correspond with Derivative 3, the total return swap is indexed to an obligation to repurchase the issuer's shares and may require the issuer to settle the obligation by transferring assets. Therefore it is in the scope of this Subtopic and is required to be accounted for as a liability (or asset in some circumstances), initially, and subsequently measured at fair value. The noncontrolling interest is accounted for separately from the total return swap.

55-57 In applying paragraphs 480-10-25-4 through 25-14 to determine classification, a freestanding financial instrument within this Subtopic's scope is precluded from being combined with another freestanding financial instrument, unless combination is required under the provisions of Topic 815; therefore, unless under the particular facts and circumstances that Topic provides otherwise, freestanding derivative instruments in the scope of this Subtopic would not be combined with the noncontrolling interest.

55-58 This guidance is limited to circumstances in which the parent owns a majority of the subsidiary's outstanding common stock and consolidates that subsidiary at inception of the derivative instrument. This guidance is limited to the specific derivative instruments described.

• • > Written Put Option and Purchased Call Option Embedded in Noncontrolling Interest

55-59 If the derivative instrument in Derivative 2 is embedded in the shares (noncontrolling interest) and the shares are not otherwise classified as liabilities under the guidance in this Subtopic, the combination of options should be viewed on a combined basis with the noncontrolling interest and accounted for as a financing of the parent's purchase of the noncontrolling interest.

55-60 Under that approach, the parent would consolidate 100 percent of the subsidiary and would attribute the stated yield earned under the combined derivative instrument and noncontrolling interest position to interest expense (that is, the financing would be accreted to the strike price of the forward or option over the period until settlement). No gain or loss would be recognized on the sale of the noncontrolling interest by the parent to the noncontrolling interest holder at the inception of the derivative instrument.

55-61 The risks and rewards of owning the noncontrolling interest have been retained by the parent during the period of the derivative instrument, notwithstanding the legal ownership of the noncontrolling interest by the counterparty. Combining the two transactions in this circumstance reflects the substance of the transactions; that the counterparty is financing the noncontrolling interest. Upon such combination, the resulting instrument is not a derivative instrument subject to Subtopic 815-10.

55-62 This accounting applies even if the exercise prices of the put and call options are not equal, as long as those exercise prices are not significantly different.

7. SEC guidance on redeemable equity-classified instruments

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- 7.2.60 Are freestanding derivative instruments that are equity-classified in the scope of the temporary equity guidance? #
- 7.2.70 Are hybrid instruments with embedded derivatives indexed to, and potentially settled in, an entity's own shares in the scope of the temporary equity guidance? #
- 7.2.80 Is an equity-classified component of a convertible debt instrument in the scope of the temporary equity guidance? #
- 7.2.90 Are equity-classified preferred shares convertible to common shares in the scope of the temporary equity guidance? #
- 7.2.91 Does an entity consider Eliminated Additional Conditions #1, #6, and #7 of Subtopic 815-40 when evaluating temporary equity classification? #^^

7. SEC guidance on redeemable equity-classified instruments

- 7.2.92 Can Eliminated Additional Condition #1 be avoided if the offering is registered at inception? ^^
- 7.2.93 How are uneconomic settlement alternatives for the issuer considered in analyzing Eliminated Additional Condition #1? #^^
- 7.2.94 What are some settlement terms that are permissible under Eliminated Additional Condition #1? ^^
- 7.2.95 Does an instrument that requires an entity to pay consideration if it is unable to register the shares fail Eliminated Additional Condition #1? ^^
- 7.2.96 What are the SEC staff's views related to Eliminated Additional Condition #1? ^^
- 7.2.97 Can an instrument meet Eliminated Additional Condition #1 if it does not specify how the contract would be settled when the entity cannot deliver registered shares? ^^
- 7.2.98 Can an equity-linked financial instrument meet Eliminated Additional Condition #1 if the entity is only required to use its 'best efforts' to register the shares that will be delivered? ^^
- 7.2.99 Does the subsequent registration of shares underlying an equity-linked financial instrument issued in a private placement cause an instrument to fail Eliminated Additional Condition #1? ^^
- 7.2.100 Are securities issued under ESOPs in the scope of the temporary equity guidance?
- 7.2.110 Are share-based payment awards in the scope of the temporary equity guidance?
- 7.2.120 Are grandfathered liabilities under a previous policy choice in the scope of the temporary equity guidance?
- 7.2.130 Can entities that elect to apply the temporary equity guidance use the grandfathering provision to treat some of their redeemable preferred shares as debt?
- 7.2.140 If an instrument issued by an SEC registrant is liability-classified under Topic 480, is it subject to the temporary equity guidance?
- 7.2.150 Is it possible for an instrument with a clause that requires redemption at a fixed, future date to be subject to the temporary equity guidance?
- 7.2.160 Are the features of a separated embedded derivative considered when analyzing the host under the temporary equity guidance?

Example

7.2.10 Uneconomic settlement alternatives in an equity-linked financial instrument #^^

7.3 Classification

7.3.10 Overview

7.3.20 Identifying the redemption feature

7.3.30 Assessing the redemption feature

7.3.40 Deemed liquidation clauses

Questions

7.3.10 Is the temporary equity classification guidance applied only at initial recognition or at each reporting date?

7.3.20 Can the same instrument be classified as temporary equity at one reporting date and permanent equity at a later reporting date or vice versa?

7.3.30 What kind of contractual provisions are considered 'redemption features' in the context of the temporary equity guidance?

7.3.40 Is a 'buy-in' provision included in an equity-classified warrant to purchase common shares considered a redemption feature?

7.3.50 What redemption features are not considered when applying the temporary equity guidance?

7.3.60 Does the share-based payment WHT exemption apply if an arrangement allows for the repurchase of shares to satisfy the employer's maximum statutory tax withholding requirements?

7.3.70 If convertible debt has a fixed maturity date and a separate equity-classified component, does the fixed maturity date constitute a 'redemption date'?

7.3.80 How is an instrument classified in a subsidiary's stand-alone financial statements if it has a cash redemption feature that the parent must settle?

7.3.90 How does an issuer assess redemption features under the temporary equity guidance?

7.3.100 What are examples of redemption triggers that are solely in or not in the issuer's control?

7.3.110 Does redemption have to be in the holder's control to trigger temporary equity classification?

7.3.120 How does an issuer consider a holder redemption feature that is only exercisable if it issues new equity-classified instruments?

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- 7.3.125 How does an issuer classify shares that become redeemable by the holder if the issuer completes a merger or are redeemed on a specified date if a merger does not occur?
- 7.3.126 Is a redeemable share's classification impacted when there are limits on the total amount of instruments that can be redeemed?
- 7.3.130 What is required for an event to be 'solely in the control of the issuer'?
- 7.3.140 Does the assessment of whether redemption is solely in the control of the issuer consider only the contractual terms of the instrument?
- 7.3.150 Is the probability of redemption occurring considered in the classification assessment?
- 7.3.160 If an issuer is able to assume share settlement of some but not all of a single class of equity-classified instruments, does it classify the entire class as temporary equity?
- 7.3.170 How are knock-out clauses considered in the classification analysis?
- 7.3.180 Are contractual provisions that could transfer control over redemption away from the issuer considered at the reporting date?
- 7.3.190 Is temporary equity classification triggered when redemption requires the majority vote of the holders of the instrument?
- 7.3.200 What factors are considered to determine who controls an entity's board of directors?
- 7.3.210 How are independent directors considered when assessing whether a redemption event is in the issuer's control?
- 7.3.215 How are independent directors considered when appointment is mutually determined by board members who are common and preferred shareholders? **
- 7.3.220 Does a power held by a holder to contractually alter an instrument affect whether the issuer has sole control over the instrument's redemption?
- 7.3.230 Do deemed liquidation clauses result in temporary equity classification? #
- 7.3.240 Is the preferred shareholders' ability to obtain control of the board by acquiring a controlling stake in issuer's common shares relevant?
- 7.3.250 How is the requirement that holders of equally and more subordinated equity instruments receive the 'same form of consideration' applied?

7. SEC guidance on redeemable equity-classified instruments

Examples

- 7.3.10 [Not used]
- 7.3.20 [Not used]
- 7.3.25 Classification of redeemable shares with redemption subject to a minimum net tangible assets limitation
- 7.3.30 Evaluating whether an issuer has sufficient authorized shares to settle mandatorily convertible preferred shares and its effect on classification
- 7.3.40 Assessment of voting interests of shareholders who are board members of the same class of instruments
- 7.3.50 Assessment of voting interests of shareholders who are board members of different classes of instruments
- 7.3.60 Assessment of voting interests of independent directors in an Up-C structure
- 7.3.70 Deemed liquidation clauses
- 7.3.80 Form of consideration specified in legal agreements only for some equity instruments

7.4 Measurement

- 7.4.10 Overview
- 7.4.20 Initial measurement
- 7.4.30 Initial measurement exceptions
- 7.4.40 Subsequent measurement
- 7.4.50 Subsequent measurement exceptions
- 7.4.60 Reclassification between temporary equity and permanent equity
- 7.4.70 Redemptions, conversion and induced conversions of preferred stock

Questions

- 7.4.05 How are costs related to instruments classified as temporary equity accounted for?
- 7.4.06 How are issuance costs related to preferred shares classified as temporary equity issued with detachable stock purchase warrants accounted for?
- 7.4.10 What is the methodology for subsequently measuring instruments classified as temporary equity?
- 7.4.20 When is a temporary equity-classified instrument considered currently redeemable?
- 7.4.30 What is the appropriate subsequent measurement model for an instrument that becomes redeemable when the holder, an employee, leaves the employer?

7. SEC guidance on redeemable equity-classified instruments

- 7.4.35 What is the appropriate subsequent measurement model when redemption requires a majority vote of the instrument's holders?
- 7.4.40 How is 'probable' defined when assessing whether an instrument that is not currently redeemable will become redeemable in the future?
- 7.4.50 How is probability assessed when an instrument becomes redeemable on the future occurrence of a contingent event?
- 7.4.60 How are multiple mutually exclusive holder options considered in assessing whether an instrument will become redeemable?
- 7.4.70 When it is probable that an instrument will become redeemable in the future, is Model 1 or Model 2 preferable?
- 7.4.75 Is a redeemable instrument's subsequent measurement impacted when there are limits on the total amount of instruments that can be redeemed?
- 7.4.80 How is a subsequent remeasurement of a temporary equity-classified instrument recorded in equity?
- 7.4.90 How are multiple redemption features considered in determining the applicable subsequent measurement model and amount?
- 7.4.100 What is the appropriate measurement basis for an indexed redemption feature when redemption is contingent on the same index?
- 7.4.110 How are changes in estimates accounted for under Method 2?
- 7.4.120 How is a change from 'probable' to 'not probable' in the likelihood of an instrument becoming redeemable treated?
- 7.4.130 How is the expected earliest redemption date determined under Method 2?
- 7.4.140 How are settlement clauses other than redemption clauses considered when determining if it is probable a not-currently redeemable instrument will become redeemable in the future?
- 7.4.150 How is the subsequent measurement of an instrument affected when the holder controls the issuer's board? #
- 7.4.160 How is the maximum redemption amount determined if the redemption amount is based on a measure at a measurement date other than the reporting date?
- 7.4.170 Can an entity apply the fair value option to a temporary equity-classified instrument?
- 7.4.180 How is the subsequent measurement of a currently redeemable host contract affected when its embedded derivative is separated?

7. SEC guidance on redeemable equity-classified instruments

- 7.4.190 When preferred stock is reclassified from permanent equity to temporary equity, how is it measured at the date of reclassification?

Examples

- 7.4.10 Initial measurement of redeemable preferred shares issued with warrants that are legally detachable and separately exercisable
- 7.4.15 Issuance costs related to issuing redeemable preferred shares with freestanding warrants
- 7.4.20 [Not used]
- 7.4.30 [Not used]
- 7.4.40 Probability of the occurrence of a change in control
- 7.4.50 Determining the appropriate subsequent measurement model
- 7.4.55 Subsequent measurement of redeemable shares with redemption subject to a minimum net tangible assets limitation
- 7.4.60 Subsequent measurement of an instrument with an indexed redemption feature
- 7.4.70 Applying the accretion model – prospective method for changes in estimates
- 7.4.80 Applying the accretion model – retrospective method for changes in estimates
- 7.4.90 Applying the accretion model – fixed dollar redemption amount
- 7.4.100 [Not used]
- 7.4.110 Applying the maximum redemption amount model
- 7.4.120 Applying the maximum redemption amount model – fixed dollar redemption amount
- 7.4.130 Determining the maximum redemption amount when it is contingent on a variable metric
- 7.4.140 Reclassification of preferred shares from temporary equity to permanent equity
- 7.4.150 Reclassification of convertible preferred shares from permanent equity to temporary equity

7.5 Disclosure

- 7.5.10 Overview

Questions

- 7.5.10 Do the disclosure requirements for redeemable securities apply to redeemable instruments other than equity shares?

7. SEC guidance on redeemable equity-classified instruments

- 7.5.20 If there are no scheduled redemption dates, can the issuer disclose the redemption terms instead of the five-year table?
- 7.5.30 Can temporary equity be included in the Statement of changes of shareholders' equity?

7.1 How the standard works

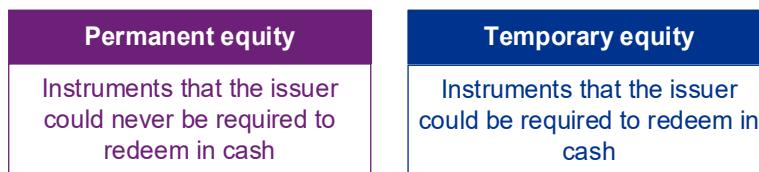
The SEC's temporary equity guidance must be evaluated for an instrument that is classified as equity. It may require that an issuer present an equity-classified instrument in 'temporary equity' (sometimes referred to as 'mezzanine equity'), which is presented below debt but outside of permanent equity on the balance sheet. This distinction is important so that financial statement users can identify which equity-classified instruments could result in future cash outflows (or other assets) from the issuer that are outside the issuer's control.

Issuer applies temporary equity guidance to:

- An instrument that is classified as equity under Topic 505
- Certain instruments that meet the requirements of Subtopic 815-40 to be classified as equity (see Question 7.2.91)

Issuer does not apply temporary equity guidance to an instrument that is classified as a liability under Topic 480 (see chapter 6) or Subtopic 815-40; see chapter 8.

The temporary equity guidance has classification, measurement and disclosure requirements. The classification of an equity-classified instrument under the temporary equity guidance is summarized as follows.



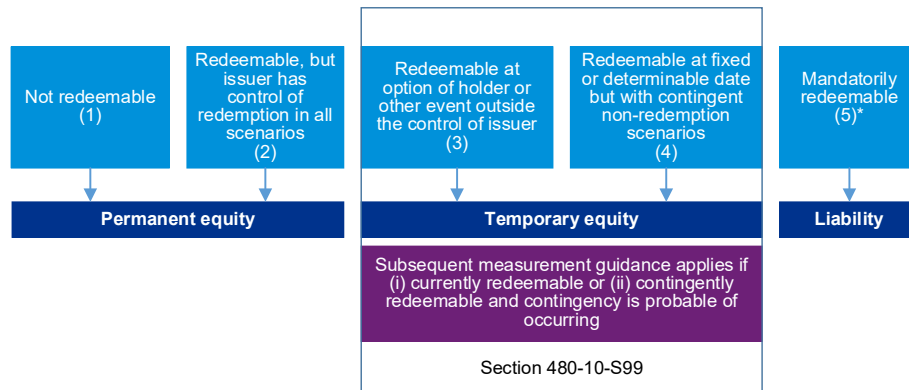
The measurement and disclosure requirements in combination enable financial statement users to understand the amount, timing and likelihood of cash outflows related to redeeming the instruments.

The temporary equity guidance can be divided into the following parts.

Scope	Classification	Measurement
<ul style="list-style-type: none"> — Scoping applies at the level of the issuer and instrument — If an instrument for an issuer is out of scope, it is classified as permanent equity — If an instrument for an issuer is in scope, the classification guidance applies 	<ul style="list-style-type: none"> — Classification is determined through a holistic assessment of the in-scope features of that instrument (i.e. inclusive of bifurcated redemption features) — To be classified as permanent equity, redemption needs to be solely within the control of the issuer — Otherwise the instrument is classified as temporary equity 	<ul style="list-style-type: none"> — Specific measurement guidance exists for certain instruments (see section 7.4.20) — For all other instruments, initial measurement is at fair value — Specific guidance applies for subsequent measurement if the instrument is (i) currently redeemable or (ii) probable of becoming redeemable

The following diagram summarizes the temporary equity guidance. It illustrates how this guidance interacts with the Codification and shows the importance of the characteristics of the redemption features for both classifying and measuring equity-classified instruments.

7. SEC guidance on redeemable equity-classified instruments



Example instruments:

- (1) Perpetual preferred shares with no conversion or redemption features.
- (2) Convertible preferred shares with conversion at the option of the holder and settled in cash or shares at the issuer's option; the issuer has sufficient authorized unissued common shares and all of the requirements of Section 815-40-25 are met for the conversion option.
- (3) Convertible preferred shares puttable by the holder for cash on the occurrence of a fundamental transaction, including a hostile takeover of the company that is outside the control of the issuer.
- (4) Convertible preferred shares that automatically convert to common stock on the occurrence of an IPO but require cash redemption in three years if an IPO does not occur before this. Occurrence of an IPO is outside the control of the issuer.
- (5) Nonconvertible preferred shares that require cash settlement in three years.

*See guidance in chapter 6 on mandatorily redeemable instruments.

Although the temporary equity guidance is principles-based, there are exemptions and exceptions to parts of the guidance.

Applying the guidance to NCI is particularly challenging, with a number of exceptions to the general guidance. The classification guidance applies to all in-scope instruments, including NCI. For a discussion on NCI, see section 7.5 of KPMG Handbook, [Consolidation](#).

Temporary equity may also affect the number of shares that are included in basic and diluted EPS. For a discussion on how instruments classified as temporary equity affect EPS, see chapter 3 of KPMG Handbook, [Earnings per share](#).

7.2 Scope

7.2.10 Overview



Excerpt from SEC Financial Reporting Releases Section 211

211.01. General

ASR 268:

On July 27, 1979, the Commission amended Regulation S-X to modify the financial statement presentation of preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. The rules adopted do not impact reporting practices of registrants not having such securities outstanding. Registrants having such securities outstanding are required to present separately, in balance sheets, amounts applicable to the following three general classes of securities: (i) preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer; (ii) preferred stocks which are not redeemable or are redeemable solely at the option of the issuer; and (iii) common stocks. A general heading, "Stockholders' Equity," is not to be used and presentation of a combined total for equity securities, inclusive of redeemable preferred stocks, is prohibited. In addition, the rules require disclosure of redemption terms, five-year maturity data, and changes in redeemable preferred stocks in a separate note to the financial statements captioned "Redeemable Preferred Stocks."

There is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital. It is expected that the rules will provide more meaningful presentation of the financial obligations of those companies which finance operations through the use of such securities.

The Commission noted an increase in the issuance, by registrants, of preferred stocks to finance operations, consummate mergers and acquisitions, or to restructure existing debt arrangements. Many of the preferred stock issues included terms which required the issuer to redeem the stock at a fixed or determinable price on a fixed or determinable date. Other issues required the issuer to redeem the stock at the option of the holder at the time certain prescribed conditions are met which are not necessarily within the control of the issuer, such as attainment of a specified level of earnings.

The Commission believes that redeemable preferred stocks are significantly different from conventional equity capital. Such securities have characteristics similar to debt and should, in the opinion of the Commission, be distinguished from permanent capital. The Commission believes that traditional financial reporting practices do not provide the most meaningful presentation of the financial obligations attached to these types of securities and that improvement in the financial statement presentation of redeemable preferred stocks is necessary.

The rules are intended to highlight the future cash obligations attached to redeemable preferred stock through appropriate balance sheet presentation and footnote disclosure. They do not attempt to deal with the conceptual question of whether such a security is a liability. Further, the rules do not attempt to deal with the income statement treatment of payments to holders of such a security or with any related income statement matters, including accounting for its extinguishment. The Commission is cognizant of these conceptual problems in determining the appropriate accounting for and reporting of redeemable preferred stock and believes that these matters can best be addressed by the FASB. As an interim measure, the rules require that the amounts applicable to redeemable preferred stock be presented in financial statements as a separate item—and not combined with equity investments not having similar redemption requirements. The Commission believes the presentation required by the rules will highlight the redemption obligation and the fact that amounts attributable to these securities are not part of permanent capital.

211.02. Definitions

ASR 268:

The following definitions apply to the terms listed below as they are used in this section:

Preferred Stock Subject to Mandatory Redemption Requirements or Whose Redemption is Outside the Control of the Issuer ("Redeemable Preferred Stock"). The term means any stock which (i) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; (ii) is redeemable at the option of the holders, or (iii) has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings. FN*.

FN* Under this definition, preferred stock which meet one or more of the above criteria would be classified as redeemable preferred stock regardless of their other attributes such as voting rights, dividend rights or conversion features.

Preferred Stocks Which Are Not Redeemable or Are Redeemable Solely at the Option of the Issuer ("Non-Redeemable Preferred Stock"). The term means any preferred stock which does not meet the criteria for classification as a "redeemable preferred stock."

211.03. Exemption

ASR 268:

The Commission has concluded that the necessary refinements concerning the presentation in financial statements of amounts applicable to redeemable preferred stocks should not impact the present reporting practices of registrants who do not use such securities to finance their operations. Therefore, registrants not having such securities may continue to use the general heading "Stockholders' Equity" and show a combined total. Where redeemable preferred stocks are outstanding, the Commission will not prohibit the combining of non-redeemable preferred stocks, common stocks and other equity accounts under an appropriate designated caption (e. g., "Non-

Redeemable Preferred Stocks, Common Stocks, and Other Stockholders' Equity") provided that any combinations be exclusive of redeemable preferred stocks.

The SEC's temporary equity guidance is applied by certain issuers (see section 7.2.20) to instruments that are not classified as liabilities under other relevant guidance. For example, instruments classified as liabilities under Subtopic 815-40 or Topic 480 are not subject to the temporary equity guidance.

The types of instruments typically subject to the temporary equity guidance include: [\[480-10-S99-3A\(3\)\]](#)

- preferred shares;
- common shares;
- share-based payment awards;
- equity-classified components of convertible debt/preferred shares; and
- NCI.

In the case of convertible debt/preferred shares, the temporary equity guidance applies to equity-classified components such as the substantial premium component in a convertible debt instrument. In this chapter, 'equity-classified instruments' refers to both equity-classified instruments and the equity-classified components of convertible debt/preferred shares (unless otherwise stated).

To be classified as permanent equity:

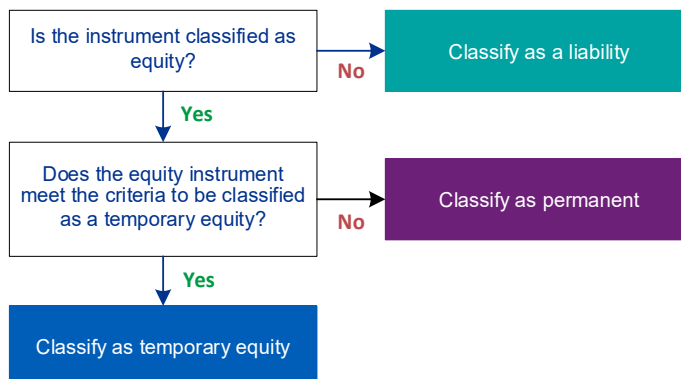
- an equity instrument must not be in the scope of the temporary equity guidance; or
- if it is in scope, it must not meet the criteria to be classified as temporary equity.



Question 7.2.10

How are equity instruments analyzed under the SEC's temporary equity guidance?

Interpretive response: The broad outline of how an equity instrument is classified under the SEC's temporary equity guidance is summarized in the following decision tree.



Whether an equity instrument falls in the scope of the temporary equity guidance is analyzed at the:

- issuer level (see section 7.2.20); and
- instrument level (see section 7.2.30).

The classification criteria are discussed in section 7.3.

7.2.20 Scoping: Issuer level

The following entities are subject to the temporary equity guidance:

- SEC registrants – e.g. public companies that prepare their financial statements under Regulation S-X; and
- other companies that state compliance with SEC rules and regulations, such as certain depository and lending institutions. [AAG-DEP 17.24]



Question 7.2.20

When must the temporary equity guidance be followed by non-SEC registrants?

Interpretive response: In some instances, the temporary equity guidance must be applied to redeemable equity instruments of the following non-SEC registrants. The following are examples.

- A private company subsidiary of an SEC registrant for purposes of the consolidated SEC registrant's financial statements. The private company is not required to follow this guidance for its stand-alone financial statements, although it might consider it anyway for ease of financial reporting. As discussed in Question 7.2.30, we believe it is preferable for all companies to apply the classification and measurement guidance for temporary equity.
 - A private company or a subsidiary of an SEC registrant for purposes of financial statements included or incorporated by reference in the SEC registrant's filings – e.g. a guarantor subsidiary's financial statements under Reg S-X Rule 3-10.
-



Question 7.2.30

Can entities apply the temporary equity guidance if they are not required to?

Interpretive response: Yes, entities that are not required to apply the temporary equity guidance may nonetheless apply it, and we believe it is preferable for all entities to do so. Further, we believe an entity that is not required to apply it may make either of the following accounting policy elections for its redeemable equity instruments, including redeemable noncontrolling interests:

7. SEC guidance on redeemable equity-classified instruments

- apply the classification and measurement principles; or
- apply the measurement principles only (see Question 5.4.15).

We believe it is particularly important for an entity to apply the guidance if it plans to become a public company in the short to medium term. When filing an IPO registration statement, an entity needs to apply the SEC's temporary equity guidance to evaluate the classification and measurement of equity instruments.

For example, even if equity-classified instruments are converted to nonredeemable common shares in an IPO, the issuer would need to analyze the instruments' redemption features to determine if they would have triggered temporary equity presentation and measurement in pre-IPO periods. If the redemption features would have triggered temporary equity classification, the issuer would need to reflect the instruments as temporary equity in the historical financial statements included in its registration statement.

Applying this guidance for the first time would be a change in accounting principle that triggers the requirements of Topic 250. Accordingly, historical financial statements would be retrospectively adjusted to reflect the application of the temporary equity guidance for comparative purposes. See chapter 3 of KPMG Handbook, [Accounting changes and error corrections](#).



Question 7.2.40

Can entities apply the temporary equity guidance to mandatorily redeemable instruments scoped out of Topic 480, even if they are not required to?

Background: Topic 480 contains a scope exception for mandatorily redeemable instruments issued by a nonpublic entity that is not an SEC registrant. Under this exception, mandatorily redeemable instruments are excluded from the scope of Topic 480 and are therefore equity-classified if they are either: [\[480-10-15-7A\]](#)

- not redeemable on fixed dates; or
- not redeemable for amounts that are either fixed or determined by reference to an interest rate index, currency index or another external index.

An example is preferred shares issued by a non-SEC registrant that are mandatorily redeemable in five years at their then fair value (see section 6.4).

Interpretive response: Yes. We believe an entity can still choose to apply the temporary equity guidance to such instruments, even if it is not required. We believe it is preferable for all entities to apply the guidance and present temporary and permanent equity separately on the balance sheet (see Question 7.2.30).

7.2.30 Scoping: Instrument level



Excerpt from ASC 480-10

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings
- • > SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

Background

1. This SEC staff announcement provides the SEC staff's views regarding the application of Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks."*^{FN1}

FN1 ASR 268 (SEC Financial Reporting Codification, Section No. 211, *Redeemable Preferred Stocks*) is incorporated into SEC Regulation S-X, Articles 5-02.27, 7-03.21, and 9-03.19. Hereafter, reference is made only to ASR 268.

Scope

2. ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. As noted in ASR 268, the Commission reasoned that "[t]here is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital."
3. Although ASR 268 specifically describes and discusses preferred securities, the SEC staff believes that ASR 268 also provides analogous guidance for other redeemable equity instruments including, for example, common stock, derivative instruments, noncontrolling interests^{FN2}, securities held by an employee stock ownership plan^{FN3}, and share-based payment arrangements with employees^{FN4}. The SEC staff's views regarding the applicability of ASR 268 in certain situations is described below.

FN2 The Master Glossary defines **noncontrolling interest** as "The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest." ASR 268 applies to redeemable noncontrolling interests (provided the redemption feature is not considered a freestanding option within the scope of Subtopic 480-10). Where relevant, specific classification and measurement guidance pertaining

7. SEC guidance on redeemable equity-classified instruments

to redeemable noncontrolling interests has been included in this SEC staff announcement.

FN3 ASR 268 applies to equity securities held by an employee stock ownership plan (whether or not allocated) that, by their terms, can be put to the registrant (sponsor) for cash or other assets. Where relevant, specific classification and measurement guidance pertaining to employee stock ownership plans has been included in this SEC staff announcement.

FN4 As indicated in Section 718-10-S99, ASR 268 applies to redeemable equity-classified instruments granted in conjunction with share-based payment arrangements with employees. Where relevant, specific classification and measurement guidance pertaining to share-based payment arrangements with employees has been included in this SEC staff announcement.

a. *Freestanding financial instruments classified as assets or liabilities.*

Freestanding financial instruments that are classified as assets or liabilities pursuant to Subtopic 480-10 or other applicable GAAP (including those that contain separated derivative assets or derivative *liabilities*) are not subject to ASR 268. ^{FN5} Mandatorily redeemable equity instruments for which the relevant portions Subtopic 480-10 have been deferred are subject to ASR 268.

FN5 An equity instrument subject to potential redemption under a freestanding written put option is not subject to ASR 268 (since the put option liability is considered a separate unit of account). However, as discussed in paragraph 3(b), when an embedded written put option has been separated from a hybrid financial instrument with an equity host contract, the host equity instrument is subject to ASR 268.

b. *Freestanding derivative instruments classified in stockholders' equity.*

Freestanding derivative instruments that are classified in stockholders' equity pursuant to Subtopic 815-40 are not subject to ASR 268. ^{FN6} Equity-classified freestanding financial instruments that were previously classified outside of permanent equity under Subtopic 815-40 are now classified as assets or liabilities pursuant to Subtopic 480-10. However, Subtopic 815-40 continues to apply to embedded derivatives indexed to, and potentially settled in, a company's own stock. Accordingly, when a hybrid financial instrument that is not *classified* in its entirety as an asset or liability under Subtopic 480-10 or other applicable GAAP contains an embedded derivative within the scope of Subtopic 815-40, the registrant should consider the applicability of ASR 268 to:

- The hybrid financial instrument when the embedded derivative is not separated under Subtopic 815-15, or
- The host contract when the embedded derivative is separated under Subtopic 815-15.

FN6 A freestanding derivative instrument would not meet the conditions in Subtopic 815-40 to be classified as an equity instrument if it was subject to redemption for cash or other assets on a specified

7. SEC guidance on redeemable equity-classified instruments

date or upon the occurrence of an event that is not within the control of the issuer.

- c. *Equity instruments subject to registration payment arrangements.* The determination of whether an equity instrument subject to a registration payment arrangement (as defined in Paragraph 825-20-15-3) is subject to ASR 268 should be made without regard to the *existence* of the registration payment arrangement (that is, the registration payment arrangement is a separate unit of account). However, in determining the applicability of ASR 268 to an equity *instrument* with any other related arrangement, a conclusion that the related arrangement is a separate unit of account should not be based on an analogy to Paragraph 815-10-25-16.
- d. *Share-based payment awards.* Equity-classified share-based payment arrangements with employees are not subject to ASR 268 due solely to either of the following:
- Net cash settlement would be assumed pursuant to Paragraphs 815-40-25-11 through 25-16 solely because of an obligation to deliver registered shares. ^{FN7}
 - A provision in an instrument for the direct or indirect repurchase of shares issued to an employee exists solely to satisfy the employer's statutory tax withholding requirements (as discussed in Paragraph 718-10-25-18).

FN7 See footnote 84 of Section 718-10-S99.

- e. *Convertible debt instruments that contain a separately classified equity component.* Other applicable GAAP may require a convertible debt *instrument* to be separated into a liability component and an equity component. ^{FN8} In these situations, the equity-classified component of the convertible debt instrument should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash or other assets (that is, the instrument is currently redeemable or convertible for cash or other assets). For these instruments, an assessment of whether the convertible debt instrument will become redeemable or convertible for cash or other assets at a future date should not be made. For example, a convertible debt instrument that is not redeemable at the balance sheet date but could become redeemable by the holder of the instrument in the future based on the passage of time or upon the occurrence of a contingent event is not considered currently redeemable at the balance sheet date.

FN8 See Subtopics 470-20 and 470-50; and Paragraph 815-15-35-4.

- f. *Certain redemptions upon liquidation events.* Ordinary liquidation events, which involve the redemption and liquidation of all of an entity's equity instruments for cash or other assets of the entity, do not result in an equity instrument being subject to ASR 268. In other words, if the payment of cash or other assets is required only from the distribution of net assets upon the final liquidation or termination of an entity (which may be a less-than-wholly-owned consolidated subsidiary), then that potential event need not be considered when applying ASR 268. Other transactions are considered deemed liquidation events. For example, the contractual provisions of an equity instrument may require its redemption by the issuer

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upon the occurrence of a change-in-control that does not result in the liquidation or termination of the issuing entity, a delisting of the issuer's securities from an exchange, or the violation of a debt covenant. Deemed liquidation events that require (or permit at the holder's option) the redemption of only one or more particular class of equity instrument for cash or other assets cause those instruments to be subject to ASR 268. However, as a limited exception, a deemed liquidation event does not cause a particular class of equity instrument to be classified outside of permanent equity if all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem).

- g. *Certain redemptions covered by insurance proceeds.* As a limited exception that should not be analogized to, an equity instrument that becomes redeemable upon the death of the holder (at the option of the holder's heir or estate^{FN9}) or upon the *disability* of the holder is not subject to ASR 268 if the redemption amount will be funded from the proceeds of an insurance policy that is currently in force and which the registrant has the intent and ability to maintain in force.

FN9 If an equity instrument is required to be redeemed for cash or other assets upon the death of the holder, the instrument is classified as a liability pursuant to Subtopic 480-10 even if an insurance policy would fund the redemption.

Generally, the temporary equity guidance applies to all instruments (and components of instruments) that are equity-classified. In fact, the guidance does not exempt any types of instruments entirely from its scope. Instead, it clarifies how the guidance interacts with Codification Topics and demonstrates how it is applied to specific instruments.

The following table summarizes some of the instrument-level scope guidance included in the temporary equity guidance.

Instruments	Scope conclusion
1. Freestanding financial instruments classified as assets or liabilities	Out of scope (see Question 7.2.50)
2. Freestanding derivative instruments that are equity-classified	In scope (see Question 7.2.60)*
3. Hybrid instruments with embedded derivatives indexed to, and potentially settled in, an entity's own shares	Component classified in equity is in scope (see Question 7.2.70)*
4. Equity-classified components of convertible debt instruments	In scope (see Question 7.2.80)*
5. Equity-classified preferred shares convertible to common shares	In scope (see Question 7.2.90)*
6. ESOPs	In scope (see Question 7.2.100)

Instruments	Scope conclusion
7. Share-based payment awards (equity-classified)	In scope (see Question 7.2.110)
8. Grandfathered liabilities under a previous accounting policy choice	Out of scope (see Questions 7.2.120 and 7.2.130)

*In addition to the analysis in the indicated Questions, the analysis in Questions 7.2.91 to 7.2.99 is also relevant in determining whether these instruments are to be classified as temporary equity.



Question 7.2.50

Are freestanding financial instruments classified as assets or liabilities in the scope of the temporary equity guidance?

Interpretive response: No. If a freestanding financial instrument is classified as an asset or liability, the instrument is not in the scope of the SEC's temporary equity guidance because it is not equity-classified. [480-10-S99-3A(3a)]

Instruments that are classified as assets or liabilities under FASB guidance include:

- instruments issued that are mandatorily redeemable (see chapter 6); and
- contracts in an issuer's own equity not classified as equity; see chapter 8.



Question 7.2.60#

Are freestanding derivative instruments that are equity-classified in the scope of the temporary equity guidance?

Interpretive response: It depends. As discussed in Question 7.2.91, we believe – in the absence of guidance from the SEC staff – an entity should consider the conditions eliminated from Section 815-40-25 (as a result of ASU 2020-06) when evaluating temporary equity classification (i.e. Eliminated Additional Conditions #1, #6 and #7).



Question 7.2.70#

Are hybrid instruments with embedded derivatives indexed to, and potentially settled in, an entity's own shares in the scope of the temporary equity guidance?

Interpretive response: It depends. A hybrid financial instrument is one in which either:

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- a. the entire instrument is classified as equity – i.e. the embedded derivative does not require separation (see chapter 9); or
- b. the embedded derivative is separated and does not qualify as equity, but the host instrument is equity-classified – e.g. convertible preferred shares for which the conversion option is based on the S&P 500 index reaching a certain return.

In scope instruments

The temporary equity guidance is applied: [480-10-S99-3A(3b)]

- in the case of (a), to the entire hybrid instrument; or
- in the case of (b), to the equity-classified host instrument (see Question 7.2.160).

As discussed in Question 7.2.91, we believe – in the absence of guidance from the SEC staff – an entity should consider the conditions eliminated from Section 815-40-25 (as a result of ASU 2020-06) when evaluating temporary equity classification (i.e. Eliminated Additional Conditions #1, #6 and #7).

Out of scope instruments

A hybrid instrument is outside the scope of the temporary equity guidance if:

- its host contract is liability-classified; and
- it has a bifurcated embedded derivative that does not qualify as equity – e.g. a convertible bond for which the conversion option does not qualify for equity-classification; see section 10.3.

Such a hybrid instrument is outside the scope of the temporary equity guidance because neither the debt host nor the embedded derivative is classified in equity.

**Question 7.2.80#**

Is an equity-classified component of a convertible debt instrument in the scope of the temporary equity guidance?

Interpretive response: It depends. A convertible debt instrument that is liability-classified can have an equity-classified component. This is the case for a convertible debt instrument that:

- was issued with a substantial premium (see chapter 10);
- has a previously bifurcated conversion feature (i.e. a separated embedded derivative that was initially recognized as an asset/liability) that is no longer required to be bifurcated and therefore has been reclassified to equity (see chapter 10); or
- has been modified or exchanged in a transaction that did not qualify for extinguishment accounting and that involved an increase in the fair value of the embedded conversion feature, which is recognized in equity (see chapter 10).

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The temporary equity guidance is applied to the equity-classified component if the convertible debt is either: [\[480-10-S99-3A\(3e\)\]](#)

- redeemable for cash at the reporting date – i.e. puttable by the holder;
- convertible for cash or other assets of the entity at the reporting date – e.g. a convertible debt instrument required to be settled on conversion in cash up to the accreted value or:
- the equity classified component permits share-settlement or (net) cash settlement.

The scope section of the guidance contains specific redemption feature-level exceptions for these equity-classified components (see section 7.3.20).

Equity-classified components of convertible debt instruments (and convertible preferred shares classified as liabilities) are subject to specific measurement exceptions (see sections 7.4.30 and 7.4.50).

As discussed in Question 7.2.91, in the absence of guidance from the SEC staff, we believe an entity should consider the conditions eliminated from Section 815-40-25 (as a result of ASU 2020-06) when evaluating temporary equity classification (i.e. Eliminated Additional Conditions #1, #6 and #7).



Question 7.2.90#

Are equity-classified preferred shares convertible to common shares in the scope of the temporary equity guidance?

Interpretive response: It depends. The temporary equity guidance applies to instruments or components of instruments that are otherwise equity-classified but may require the issuer to redeem them for cash or other assets. Instruments or components of instruments that give the issuer the option to settle in shares or cash may be in the scope of the temporary equity guidance if the issuer is unable to assert share settlement after considering the requirements in Section 815-40-25 (see chapter 8). [\[480-10-S99-3A\(2\), S99-3A\(6\)\]](#)

For example, a convertible preferred share that is equity-classified may have a conversion option for the holder to convert it to the issuer's common shares. Because the conversion is not in the issuer's control, the issuer analyzes the requirements in Section 815-40-25. If the issuer cannot assert share settlement, it presumes cash settlement would be required, in which case the instrument must be classified as temporary equity.

As discussed in Question 7.2.91, in the absence of guidance from the SEC staff, we believe an entity should consider the conditions eliminated from Section 815-40-25 when evaluating temporary equity classification (i.e. Eliminated Additional Conditions #1, #6 and #7).



Question 7.2.91#^^

Does an entity consider Eliminated Additional Conditions #1, #6, and #7 of Subtopic 815-40 when evaluating temporary equity classification?

Background: As discussed in section 8.1 and Question 8.12.10, ASU 2020-06 amended the equity-classification requirements for a freestanding instrument (or embedded derivative) that is potentially settled in an entity's own shares. Before the ASU, Subtopic 815-40 included seven additional conditions that had to be met for a contract to be classified in equity (or for an embedded derivative to meet the derivative scope exception). If the additional conditions were not met, equity classification was precluded because the contract might (or would) have to be settled in cash rather than shares.

The ASU removed three of those conditions (referred to in this chapter as Eliminated Additional Conditions #1, #6 and #7) from Subtopic 815-40's equity classification requirements. However, the SEC temporary equity classification guidance has not been similarly amended to reflect the elimination of these conditions in Subtopic 815-40. Moreover, there is a view that these Eliminated Additional Conditions remain relevant to the temporary equity classification guidance because the failure to meet one or more of them may indicate that the entity does not control the ability to share-settle a contract, which in turn would require temporary equity classification of the instrument.

Interpretive response: Yes. Based on informal discussions with the SEC staff, the staff has recognized that it is unclear whether an entity has to consider the Eliminated Additional Conditions when applying the temporary equity guidance. In the absence of guidance from the SEC staff, we believe an entity should consider these conditions when evaluating temporary equity classification because these conditions may indicate that the entity does not control the ability to share-settle a contract. For example, an entity that is legally required to issue registered shares to share-settle a contract does not control that ability. If an entity decides not to consider the eliminated conditions, it should preclear its decision with the SEC staff.

Summary of Eliminated Additional Conditions

Eliminated Additional Condition #1

This condition is met if the contract allows the entity to settle the instrument in unregistered shares; therefore, it focuses on an entity's legal ability to settle a contract in shares. However, the Securities Act of 1933 requires offers and sales of securities to be registered with the SEC unless a specific exemption applies. The events or actions necessary to register the shares are not controlled by an entity. Therefore, if the terms of an equity-linked financial instrument require the entity to deliver registered shares upon exercise, it is assumed that the entity will be required to cash-settle the instrument upon exercise.

Eliminated Additional Condition #6

This condition is met if the holder of an equity-classified financial instrument does not have rights that rank higher than the rights of the entity's shareholders.

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When an entity is in bankruptcy, the claims of a creditor (e.g. a debt holder or a vendor) have priority over the claims of the holders of the entity's equity interests. In other words, creditors' rights rank higher than equity holders' rights.

However, if an instrument includes a provision that requires net-cash settlement in the event of bankruptcy, this condition may still be met. This is because the automatic stay provisions of the Bankruptcy Code prohibit the entity in bankruptcy from settling any obligations without Bankruptcy Court approval (and prohibit counterparties to the entity's claims from seeking settlement of the claims). For this condition to be met, either of these scenarios must exist:

- the instrument could be net-share settled, notwithstanding the terms of the contract; or
- the holder's claims in bankruptcy proceedings of the entity rank no higher than the claims of the holders of the underlying stock.

This is a legal determination that typically involves legal counsel.

Eliminated Additional Condition #7

This condition is met if the instrument does not require the entity to post collateral (other than the instrument's underlying shares up to the maximum number of shares that could be delivered under the contract) at any time or for any reason.



Question 7.2.92^^

Can Eliminated Additional Condition #1 be avoided if the offering is registered at inception?

Interpretive response: It depends. Even if an offering is registered at inception, an entity is generally required to maintain timely filing status to continue to be eligible to issue shares, unless the offering qualifies for an exemption under the securities laws.

The ability to maintain timely filing status is not considered to be in an entity's control – e.g. because the entity cannot control whether its auditor will issue an unqualified audit opinion in a timely manner. Therefore, if the terms of an equity-linked financial instrument require an entity to deliver registered shares upon exercise, and the contract is silent as to what would happen if the entity were unable to do so, it is assumed that the entity will be required to cash-settle the instrument upon exercise.



Question 7.2.93#^^

How are uneconomic settlement alternatives for the issuer considered in analyzing Eliminated Additional Condition #1?

Background: Question 7.2.91 explains that ASU 2020-06 eliminated from Subtopic 815-40 three Additional Conditions (including Additional Condition #1) that may indicate the entity does not control the ability to share-settle a contract. In that Question, we conclude that these now eliminated conditions should be considered when determining whether the temporary equity guidance applies. Therefore, we refer to former Additional Condition #1 as Eliminated Condition #1.

Interpretive response: If a settlement alternative is uneconomic to the issuer (e.g. because it contains a penalty or a settlement alternative that is significantly more costly than other settlement alternatives), the issuer assumes that the uneconomic settlement alternative will not be taken. [815-40-25-18]



Question 7.2.94^^

What are some settlement terms that are permissible under Eliminated Additional Condition #1?

Interpretive response: The following settlement terms in a contract are permissible under Eliminated Additional Condition #1, meaning their presence does not undermine the issuer's ability to net-share settle.

- The instrument allows for settlement in unregistered shares – as long as there have been no failed registration statements within the preceding six months.
- If settlement in unregistered shares is permitted, a discount between the fair value of the unregistered shares delivered and the corresponding registered shares is determined at the date of settlement using commercially reasonable means.
- The contract specifies that the issuer is not required to net-cash settle the contract if it is unable to deliver registered shares.
- The shares to be delivered at settlement are registered at inception of the transaction and there are no further timely filing or registration requirements.

**Question 7.2.95^^****Does an instrument that requires an entity to pay consideration if it is unable to register the shares fail Eliminated Additional Condition #1?**

Interpretive response: It depends. Sometimes the provisions of an instrument allow for settlement in unregistered shares but require the entity to pay consideration to the holder if it is unable to register the shares underlying the instrument.

Arrangements such as this will not indicate net-cash settlement if they meet the definition of a registration payment arrangement. This is because registration payment arrangements are considered a separate unit of account (see Question 8.3.10).

**Example 7.2.10#^^****Uneconomic settlement alternatives in an equity-linked financial instrument**

Issuer issues warrants that permit Holder to purchase 100 shares of its common stock for \$5 per share. The warrants have a 20-year term and are exercisable at any time.

The terms of the warrants give Issuer the option to either net-share or net-cash settle the warrants. However, if Issuer elects net-share settlement, it is required to provide Holder with a penalty of 1,000 additional shares.

Issuer concludes that the warrants meet the requirements of the indexation guidance and the equity classification guidance to be able to apply the derivative scope exception in Subtopic 815-40 and therefore equity classification is not precluded.

The terms of the instrument allow Issuer to elect either cash or share settlement; however, because the substance of this agreement is such that Issuer would avoid a significant penalty if it were to net-cash settle the warrants, it is assumed that the uneconomic settlement alternative of net-share settlement will not be taken, and therefore Issuer classifies the warrants as temporary equity.

**Question 7.2.96^^****What are the SEC staff's views related to Eliminated Additional Condition #1?**

Interpretive response: In the context of whether Eliminated Additional Condition #1 applies, the SEC staff has discussed the issue of registration requirements and provided several examples of securities, and its interpretation

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of the US securities laws and requirements applicable to them. The main themes are as follows: [\[2006 AICPA Conf\]](#)

- a complete understanding of the terms of the instrument and a thorough understanding of the US securities laws is necessary; and
- events or actions to deliver registered shares are generally not controlled by the issuer of the shares.

The information below is a general summary and should not be relied on for specific legal conclusions. An expert in US securities laws should be consulted to conclude on whether an entity is permitted to settle an equity-linked financial instrument in unregistered shares.

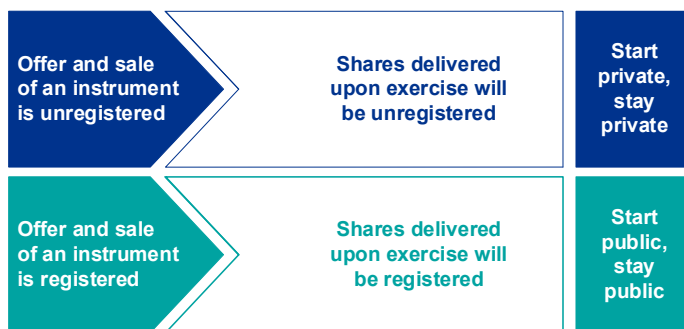
Ability to settle in unregistered shares

To appropriately analyze whether an instrument meets the requirement that settlement is permitted in unregistered shares, it is important to first understand the following.

- The provisions of the Securities Act of 1933 apply to transactions, not to securities – i.e. when reference is made to registration under the Securities Act, it refers to registration of the offers and sales of securities, and not to the securities themselves.
- The Securities Act provides some exemptions for certain transactions, and the evaluation of whether an exemption is available for a transaction and a determination of when an exemption is needed must be made for both the offer and the sale.

The SEC staff reiterated that the ability to settle in unregistered shares is a legal analysis and cannot be assumed. The staff noted that under the securities laws whether shares delivered upon exercise of an equity-linked financial instrument are required to be registered or unregistered depends on how the instrument was offered. [\[2006 AICPA Conf\]](#)

The following diagram illustrates the impact of an unregistered offer and sale of an instrument compared to a registered offer and sale. The concepts summarized in the diagram are further explained below.



The Securities Act requires that all offers and sales of securities for value be registered, unless the offer and sale associated with a transaction is 'exempt'. Therefore, the 'start public, stay public' offering concept usually applies.

'Start private, stay private' offering

In a 'start private, stay private' offering, the SEC staff discussed an example of a securities offering that is exempt because it does not involve a public offering. This is also referred to as the 'private placement exemption'. In the example discussed by the staff, the entity conducts an offering of both shares of common stock and warrants to purchase common stock. For the offer to qualify for the private placement exemption, the entity offers 'units' consisting of common stock and warrants to purchase common stock.

Concurrent with the offering of these units, the unregistered offering of the underlying securities (i.e. the common stock, the warrants and the common stock underlying the warrants) commences. Once the entity sells the common stock and the warrants, they are restricted because they were issued in a nonpublic offering. However, the offering of the common stock underlying the warrants is ongoing until the warrants' term expires, or the warrants are exercised. This is because the investment decision with respect to the warrants is not complete.

Consequently, while the warrants are outstanding, the sale of the shares underlying the warrants is required to either be registered or qualify for an exemption. However, in this scenario, the entity would not be able to pursue the option of registering the offer and sale of the shares underlying the warrants because the entity has already privately commenced the offer of the shares underlying the warrants. As a result, the entity has to find an exemption with respect to the offering of the shares underlying the warrants.

'Start public, stay public' offering

In contrast, in a 'start public, stay public' offering of an equity-linked instrument such as warrants, not only will the warrants need to be registered for resale, but the associated offers and sales of the underlying shares will also need to be registered. Because the offering process of the shares underlying the warrants was conducted publicly, it will not be possible for the entity to claim a private placement exemption. Therefore, for an equity-linked instrument issued in a 'start public, stay public' offering, the right to settle in unregistered shares cannot be assumed.

The following are remarks by the SEC staff. [\[2006 AICPA Conf\]](#)

**Excerpt from SEC speech**

...It is important to note that we have seen numerous situations where registrants have tried to assert that the contract permits settlement in unregistered shares. This assertion appears to stem from the fact that oftentimes the contract itself does not specifically state that the company must settle in registered shares. However, US Securities Laws may implicitly require settlement in registered shares because the company will not be able to find an exemption from registration and therefore settling in unregistered (or restricted) shares would be a violation of US Securities Laws.

As mentioned earlier, if the warrants were sold in a registered offering, there will likely not be an exemption available to the company for the sale of the shares underlying the warrants...The staff believes that if the warrant

agreement requires delivery of registered shares, does not specify how the contract would be settled in the event the company is unable to deliver registered shares, and does not specify any circumstances under which net cash settlement would be permitted or required, net cash settlement must be assumed since it is unlikely that noncompliance is an acceptable alternative.

Stephanie L. Hunsaker, Remarks before the 2006 AICPA National Conference on Current SEC and PCAOB Developments

Ongoing timely filing or registration requirements

The SEC staff emphasized that, pursuant to paragraph 815-40-25-16 (which has since been superseded), the requirement for share delivery to be in the entity's control is met if a derivative instrument involves the delivery of shares at settlement that are registered at the inception of the derivative instrument and there are no further timely filing or registration requirements. This may be true for a forward contract to sell shares on a preset date in the future. The SEC staff said that in a share purchase contract, the decision to purchase the common shares in the future was made at the contract's inception and therefore the arrangement is just a delayed delivery of the common stock.

In practice, the entity may be subject to periodic filing requirements pursuant to the Securities Exchange Act of 1934 (e.g. Form 10-K, 10-Q). In those cases, the exemption in superseded paragraph 815-40-25-16 cannot be used. Entities should therefore consult legal counsel to make this determination.

In contrast, if further investment decisions need to be made by the holder at the time of exercise of an instrument, further timely filing or registration requirements would typically apply. The SEC staff noted that the issuer of warrants would have to deliver a current prospectus to the holders in connection with any exercises by them, which could influence the holder's decision on whether to exercise the warrants. In other words, the holder of the warrant has to make a separate investment decision at the time of exercise of the warrants and therefore the issuer has to deliver a current prospectus to the holder.

Finally, the SEC staff also discussed a specific exemption under Section 3(a)(9) of the Securities Act that may be relevant when evaluating whether there are ongoing timely filing or registration requirements. This exemption relates to the exchange of one class of securities of an entity for a different class of securities of the same entity, in which no consideration or commissions are paid – e.g. conversion of a convertible debenture or convertible preferred stock.

Entity not required to net-cash settle the instrument in any circumstance

The SEC staff indicated that in certain rare circumstances it has observed that there may be a clause in a registered unit offering indicating that in the event the entity does not have an effective registration statement, there is no circumstance that would require the entity to net-cash settle the warrants. In that case, the staff indicated it would not object to the entity's conclusion that the provisions are consistent with the requirements of superseded paragraph 815-40-25-10(a) that settlement is permitted in unregistered shares.



Question 7.2.97^^

Can an instrument meet Eliminated Additional Condition #1 if it does not specify how the contract would be settled when the entity cannot deliver registered shares?

Background: Assume that an entity issues an equity-linked financial instrument that does not permit net-cash settlement and requires physical delivery of registered shares. The terms of the instrument are silent on the settlement mechanism if the entity is unable to deliver registered shares.

Interpretive response: No. If its terms are silent on the settlement mechanism when the entity is unable to deliver registered shares, settlement in unregistered cannot be presumed. Because the events or actions necessary to deliver registered shares are not controlled by the entity, it is assumed that the entity will be required to net-cash settle the contract if it is unable to deliver registered shares. Net-cash settlement is also assumed if the contract does not specify how it should be settled if the entity is unable to deliver registered shares.



Question 7.2.98^^

Can an equity-linked financial instrument meet Eliminated Additional Condition #1 if the entity is only required to use its 'best efforts' to register the shares that will be delivered?

Background: An entity issues an equity-linked financial instrument that it is permitted to settle with unregistered shares. However, the terms of the agreement include a requirement that the entity use its 'best efforts' to register the shares and to pay for the registration costs.

Interpretive response: Yes. Eliminated Additional Condition #1 requires that an instrument permit settlement in unregistered shares. This is because, if the entity is unable to register the shares (which is an event outside its control), it could be forced to net-cash settle the instrument.

However, a requirement for the entity to only use its 'best efforts' to register the shares (which is an event in its control) would not cause net-cash settlement to be presumed.

Provisions such as this sometimes meet the definition of a registration payment arrangement (see Question 8.3.10).



Question 7.2.99^^

Does the subsequent registration of shares underlying an equity-linked financial instrument issued in a private placement cause an instrument to fail Eliminated Additional Condition #1?

Background: An entity issues private placement warrants along with a resale registration payment arrangement that indicates it is required to use its best efforts to register the resale of the shares to be delivered upon settlement of the warrants (i.e. for resale by the holder). As discussed in Question 7.2.96, the offers and sales of securities are registered with the SEC, not the securities themselves.

The warrants meet all the requirements of the indexation and the equity classification guidance. Therefore, the entity classifies the warrants as equity on issuance. Subsequent to issuance, but while the warrants are still outstanding, the entity registers the subsequent resale of the shares to be delivered upon settlement of the warrants (i.e. for resale by the holder).

Interpretive response: No. As discussed in Question 7.2.96, net-cash settlement is not presumed if:

- the offer and sale of an instrument is unregistered (as is the case with private placement warrants); and
- the instrument is assumed to permit settlement in unregistered shares.

As discussed in Question 7.2.96, the SEC refers to this type of transaction as a ‘start private, stay private’ offering.

In this case, the instrument is presumed to permit settlement in unregistered shares. This is because, in a start private, stay private offering, the offer of the shares to be delivered on exercise of the warrants is privately commenced with the offer of the warrants. Therefore, the entity is legally prohibited from using a registration statement to offer and sell the underlying shares that will be delivered on exercise of the warrants. However, the entity is permitted to register the resale of the shares (by the holder) to be delivered upon settlement of the warrants. [\[2006 AICPA Conf\]](#)

To provide the holder with the ability to resell the shares obtained on exercise of the warrants issued in a private placement, the entity and the holder sometimes enter into a resale registration rights agreement concurrent with the instrument. This agreement requires the entity to use its best efforts to register the shares received by the warrant holder upon their exercise (hence the term resale in the description of such an agreement). [\[2006 AICPA Conf\]](#)

Questions have arisen as to whether the subsequent registration of shares received by the warrant holder for resale affects the classification of the warrants. However, because the existence of the resale registration rights agreement does not affect the ability to settle the private placement warrants in unregistered shares, we believe that warrants that are issued with a registration payment arrangement are not precluded from equity classification once those shares are registered.



Question 7.2.100

Are securities issued under ESOPs in the scope of the temporary equity guidance?

Interpretive response: It depends.

Under federal income tax regulations, employer securities (e.g. convertible preferred shares) that are held by participants in an ESOP and that are not readily tradeable on an established market must include a put option.

The put option gives the employee the right to redeem the employer securities for an established cash price. The employer may have the option to issue marketable securities for all or a portion of that redemption amount instead of paying cash. If the option is to pay a portion in marketable securities and the remaining market value is 'topped up' in cash, this is termed a 'market value guarantee feature'.

Securities issued under ESOPs that are equity-classified are in the scope of the temporary equity guidance and the put option written to the employee will trigger temporary equity classification. [\[480-10-S99-3A\(3\)\]](#)

ESOPs with a market value guarantee feature are subject to specific measurement exceptions (see sections 7.4.30 and 7.4.50).



Question 7.2.110

Are share-based payment awards in the scope of the temporary equity guidance?

Interpretive response: It depends. In many cases, instruments that are redeemable are liability-classified under Topic 718, and therefore the temporary equity guidance does not apply. However, not all redemption features trigger liability classification; therefore, these instruments can be equity-classified. If an equity-classified share-based payment arrangement involves a redeemable instrument, the temporary equity guidance is applied to determine the amount of an award, if any, to be presented in temporary equity. [\[480-10-S99-3A\(3d\)\]](#)

An example of a redemption feature that does not trigger liability classification under Topic 718 is the right of participants to sell shares back to the issuer at fair value after they have held them for six months or longer. Because redemption is outside the issuer's control, this clause results in the need to recognize some amount in temporary equity. Alternatively, if the issuer (not the participant) has the option to repurchase the shares, then redemption is in the issuer's control and temporary equity classification is not appropriate.

For further guidance on the interaction between Topic 718 and the temporary equity guidance, see chapter 3 in KPMG Handbook, [Share-based payment](#).

Specific redemption feature-level exceptions apply to share-based payment awards (see Question 7.3.50). Share-based payment awards are subject to specific measurement exceptions (see section 7.4.30).



Question 7.2.120

Are grandfathered liabilities under a previous policy choice in the scope of the temporary equity guidance?

Background: Historically, the SEC staff has not objected to redeemable preferred shares being presented as debt before the first fiscal quarter beginning after September 15, 2007 even if they met the requirements for temporary equity classification. The SEC staff permitted debt presentation as long as it was consistent, including classifying dividends payable on the redeemable preferred shares as interest expense. [480-10-S99-3A(4)]

Interpretive response: No. The SEC staff continues to allow these grandfathered instruments to be presented as debt if the issuer had made the policy choice to do so, meaning the temporary equity guidance does not apply to them. This policy choice is not available for any such instruments originated, modified or otherwise subject to a remeasurement (new basis) event after the first fiscal quarter beginning after September 15, 2007 (see Question 7.2.130).



Question 7.2.130

Can entities that elect to apply the temporary equity guidance use the grandfathering provision to treat some of their redeemable preferred shares as debt?

Interpretive response: Yes. We believe entities that elect to apply the temporary equity guidance (even if they are not required) may also present redeemable preferred shares as debt when they have been recorded as debt prior to the first fiscal quarter beginning after September 15, 2007 if this policy election is selected.

This is consistent with our view that all entities can apply temporary equity guidance (see Question 7.2.30).



Question 7.2.140

If an instrument issued by an SEC registrant is liability-classified under Topic 480, is it subject to the temporary equity guidance?

Interpretive response: No. The temporary equity guidance applies only to equity-classified instruments or equity-classified components of instruments. Because instruments in the scope of the other sections of Topic 480 related to distinguishing between equity and liabilities are classified as liabilities, these instruments are not subject to the temporary equity guidance.

Further, we understand the SEC staff would object to presenting equity-classified redeemable equity securities that qualify as temporary equity as a liability.



Question 7.2.150

Is it possible for an instrument with a clause that requires redemption at a fixed, future date to be subject to the temporary equity guidance?

Interpretive response: Yes. That feature on its own would mean that the instrument was mandatorily redeemable and therefore classified as a liability under Topic 480 (see chapter 6). However, the instrument is not liability-classified if it contains a ‘knock-out clause’, which is an additional clause that could be activated before the fixed, future redemption date that would not result in the issuer settling in cash, other assets or other mandatorily redeemable shares. An instrument with such a knock-out clause is assessed under the temporary equity guidance.

For example, a preferred share is not a liability-classified mandatorily redeemable instrument under Topic 480 even though the issuer is required to redeem the share on its maturity date if the holder has an option to convert the share to nonredeemable common shares at any time during the share’s term. Such a share is assessed under the temporary equity guidance (see Question 7.3.170).



Question 7.2.160

Are the features of a separated embedded derivative considered when analyzing the host under the temporary equity guidance?

Interpretive response: Yes. Although the embedded derivative is presented separately from the equity host as an asset or liability, we believe the analysis should consider all of the terms and features of both the embedded derivative and the equity host in assessing the classification of the equity-classified host under the temporary equity guidance.

An example of an instrument to which this guidance applies is equity-classified preferred shares with an embedded put option that has been bifurcated under the guidance in Subtopic 815-15. [480-10-S99-3A(3)(a)(FN5)].

7.3 Classification

7.3.10 Overview



Excerpt from ASC 480-10

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings
- • > SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

Classification

1. ASR 268 requires equity instruments with redemption features that are not solely within the control of the issuer to be classified outside of permanent equity (often referred to as classification in "temporary equity"). The SEC staff does not believe it is appropriate to classify a financial instrument (or host contract) that meets the conditions for temporary equity classification under ASR 268 as a liability.^{FN10}

FN10 At the June 14, 2007 EITF meeting, the SEC Observer stated that a financial instrument (or host contract) that otherwise meets the conditions for temporary equity classification may continue to be classified as a liability provided the financial instrument (or host contract) was classified and accounted for as a liability in fiscal quarters beginning before September 15, 2007 and has not subsequently been modified or subject to a remeasurement (new basis) event.

Once an issuer determines that an equity-classified instrument is in the scope of the temporary equity guidance, it then applies the classification guidance to determine whether the instrument should be classified as temporary equity.

This classification guidance requires a holistic assessment of the instrument, including consideration of both embedded and bifurcated features (unless scoped out, see Question 7.3.50) to determine whether:

- the holder has, or will have, the ability to redeem the instrument at its option; or
- if redemption can take place on the occurrence of an event that is not solely in the issuer's control.

If the issuer cannot prevent redemption by the holder or does not control the occurrence of the event(s) that would require redemption or allow the holder to redeem, the instrument is classified as temporary equity. [\[480-10-S99-3A\(4\)\]](#)

The classification guidance applies to all instruments that are in scope, including NCI. For a discussion on redeemable NCI, see section 7.5 of KPMG Handbook, [Consolidation](#).

**Question 7.3.10****Is the temporary equity classification guidance applied only at initial recognition or at each reporting date?**

Interpretive response: The temporary equity guidance is clear that measurement of a temporary equity-classified instrument is assessed at each reporting date. However, it does not specify whether the classification guidance is applied only at issuance or whether classification is reassessed on an ongoing basis.

We believe equity-classified instruments should be reassessed under the classification guidance at each reporting date. We believe it is appropriate to analogize to paragraph 815-40-35-8, which requires the classification of contracts in an entity's own equity to be reassessed at each date.

**Question 7.3.20****Can the same instrument be classified as temporary equity at one reporting date and permanent equity at a later reporting date or vice versa?**

Interpretive response: Yes. Because classification is assessed at each reporting date, the facts and circumstances at each reporting date are relevant (see Question 7.3.10). As a result, instruments may move between classifications.

7.3.20 Identifying the redemption feature**Excerpt from ASC 480-10**

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings
- • > SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A**Classification**

1. Determining whether an equity instrument is redeemable at the option of the holder or upon the occurrence of an event that is solely within the control of the issuer can be complex. The SEC staff believes that all of the individual facts and circumstances surrounding events that could trigger redemption should be evaluated separately and that the possibility that any triggering event that is not solely within the control of the issuer could occur—without regard to probability—would require the instrument to be

classified in temporary equity. Paragraphs 6–11 provide examples of the application of ASR 268.

Because temporary equity classification hinges on whether redemption of an instrument is beyond the issuer’s control, it is necessary to assess an instrument’s redemption features. The term ‘redemption feature’ is not defined in the temporary equity guidance or in Topic 480. However, the stated purpose of the temporary equity guidance is “to highlight the future cash obligations attached to an issued security so as to distinguish it from permanent capital.” [480-10-S99-3A]

Accordingly, it is important to identify all clauses in an instrument that might result in the issuer having to pay cash or other assets to redeem the instrument. The guidance contains a number of examples of the types of clauses that need to be assessed, which include the following. [480-10-S99-3A]

Call options

Put options

Liquidation provisions

Conversion features



Question 7.3.30

What kind of contractual provisions are considered ‘redemption features’ in the context of the temporary equity guidance?

Interpretive response: The terminology used in legal documents is varied. Often, redemption features are the result of contractual clauses that explicitly use the term ‘redemption’. However, other clauses that do not explicitly refer to ‘redemption’ may also be considered redemption features that require analysis under the temporary equity guidance – e.g. put options, call options, conversion features and liquidation clauses.

We believe a feature generally must have the following characteristics for it to be a redemption feature:

- it triggers the repurchase or the effective cancelation of the instrument, or a portion of it; and
- it is settled in cash or other assets.

Further, in a convertible preferred share, if the equity instrument issued on the holder’s conversion is redeemable and would require temporary equity classification, we believe the conversion feature in the original convertible preferred share is considered a redemption feature and triggers temporary equity classification for the preferred share. For example, Series A preferred shares are convertible to Series B at the holder’s option and Series B are redeemable in cash under circumstances outside of the issuer’s control. Both Series A and Series B preferred shares would be classified as temporary equity.

However, an embedded feature is not a ‘redemption feature’ if it is not separated and allows only for settlement in another class of existing shares of the entity (whether a fixed number of shares or a variable number of shares equal to a fixed monetary amount). It is not considered a ‘redemption feature’ in

this case because cash is not required to be provided to the holder on exercise of the embedded feature.



Question 7.3.40

Is a 'buy-in' provision included in an equity-classified warrant to purchase common shares considered a redemption feature?

Background: Certain equity-linked financial instruments (e.g. warrants to purchase common shares) contain a provision that contingently obligates the issuer to pay a cash penalty should the following occur:

- the issuer (or its transfer agent) fails to deliver the underlying shares on the holder's exercise or conversion; and
- the holder has entered into an open market transaction (i.e. short sold the shares before delivery by the issuer/transfer agent) that requires it to purchase additional amounts of the issuer's shares to cover the transaction as a result of this failure.

The payment under this penalty provision, if triggered, typically does not settle the instrument and requires the issuer to either:

- deliver the original quantity of shares that it failed to deliver; or
- deem the exercise or conversion rescinded and provide the holder with the rights under the instrument as if the exercise or conversion were never executed.

Such a provision is referred to as a 'buy-in' provision.

Interpretive response: No. As discussed in Question 8.12.150, a buy-in provision in a warrant that is equity-classified under paragraph 815-40-25-30 is considered to be a representation and warranty by the issuer to indemnify the holder if the issuer fails to deliver on its obligations. It is not considered a redemption feature and therefore not considered in the classification assessment under the temporary equity guidance.

In this case, the issuer assesses the provision (including when an exercise notification occurs) to determine if it is appropriate to recognize a contingent obligation under Topic 450 for potential delays in issuing shares.



Question 7.3.50

What redemption features are not considered when applying the temporary equity guidance?

Interpretive response: Generally, all contractual provisions of a freestanding financial instrument need to be considered. However, the temporary equity guidance contains exceptions that permit the issuer to ignore certain redemption features for the purpose of evaluating whether the instruments (or components) are temporary equity.

7. SEC guidance on redeemable equity-classified instruments

These exceptions include the following.

Redemption features	What are these features	What is the guidance?
'Ordinary' liquidation	Most equity instruments entitle the holder to cash or other assets of the issuer on its termination and liquidation if there are any remaining net assets to distribute to the equity holders.	Ordinary liquidation events where all of an issuer's equity instruments are redeemed on the issuer's final liquidation and termination are not considered when applying the temporary equity classification guidance. [480-10-S99-3A(3f)]
Share-based payment awards: obligation to deliver registered shares	Equity-classified share-based payment arrangements, which have an obligation to deliver registered shares. This exception only applies while instruments are in the scope of Topic 718. Once Topic 718 ceases to apply, the exception no longer applies. See chapter 3 of KPMG Handbook, Share-based payment .	When analyzing redemption features that permit the issuer to settle in shares at its option, the issuer assesses its capacity to issue those shares using the contracts in own equity guidance in Section 815-40-25. For instruments other than share-based payment awards, a requirement to settle in registered shares would lead to the conclusion that share settlement is not entirely in the issuer's control (see Question 7.2.91). However, this requirement is ignored when applying the temporary equity guidance to share-based payments. [480-10-S99-3A(3d)]
Share-based payment awards: WHT	Equity-classified share-based payment arrangements that allow for the direct or indirect repurchase of shares solely to satisfy the employer's statutory tax withholding requirements, as discussed in paragraphs 718-10-25-18 to 25-19 (see Question 7.3.60). This exception only applies while instruments are in the scope of Topic 718. Once Topic 718 ceases to apply, the exception no longer applies. See chapter 3 of KPMG Handbook, Share-based payment .	This feature is not considered when applying the temporary equity guidance to share-based payment awards. [480-10-S99-3A(3d)]
Future redemption clause in an equity-classified component of a	A clause that cannot be exercised at the current date, but only in the future either as a result of solely the passage of time or on the occurrence of	Redemption (and conversion) features that are not currently active but could result in redemption in the future are not considered when applying

7. SEC guidance on redeemable equity-classified instruments

Redemption features	What are these features	What is the guidance?
convertible debt instrument	a contingent event; see Question 7.2.80 for an explanation of the instruments affected.	the temporary equity guidance to the equity-classified component of a convertible instrument (see Question 7.3.70). [480-10-S99-3A(3e)]
Equity instruments subject to registration payment arrangements	A contractual provision that requires an issuer to register certain financial instruments with the applicable securities regulator as agreed or else issue or transfer consideration to the counterparty. Registration payment arrangements are accounted for as a separate unit of account under Subtopic 825-20 (registration payment arrangements).	This feature is not considered when applying the temporary equity guidance. This is a limited exception, applicable to this specific redemption feature, and should not be applied by analogy in any other circumstances. [480-10-S99-3A(3c)]
Certain equity instruments whose redemption amount is covered by insurance proceeds	A redemption feature: <ul style="list-style-type: none"> — that is contingent on the death or disability of the holder; — is at the option of the holder's beneficiary; and — will be funded from the proceeds of an in-force insurance policy that the issuer has the ability and intent to maintain in force. 	This feature is not considered when applying the temporary equity guidance. This is a limited exception, applicable to this specific redemption feature, and should not be applied by analogy in other circumstances. If an equity instrument is required to be redeemed for cash or other assets on the death of the holder, the instrument is classified as a liability by SEC registrants under Topic 480 – even if an insurance policy would fund the redemption (see chapter 6). [480-10-S99-3A(3g)]

Further, see section 7.3.40 for a discussion on deemed liquidation clauses.



Question 7.3.60

Does the share-based payment WHT exemption apply if an arrangement allows for the repurchase of shares to satisfy the employer's maximum statutory tax withholding requirements?

Interpretive response: Yes.

Before the issuance of ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, equity-classification was appropriate for a share-based

7. SEC guidance on redeemable equity-classified instruments

payment program that included the direct or indirect repurchase of the issuer's own shares only if this repurchase was solely to satisfy the **minimum** individual statutory tax rate in the applicable jurisdiction.

ASU 2016-09 amended Topic 718 to specify that such a share-based payment program may be equity-classified if the repurchase of the issuer's own shares is solely to satisfy the **maximum** individual statutory tax rate in the applicable jurisdiction. [718-10-25-18 – 25-19]

The SEC has not updated the temporary equity guidance, which still refers to the 'minimum individual statutory tax rate'. However, because the guidance references the relevant paragraphs in Topic 718, we believe the update to Topic 718 should be considered when applying the temporary equity guidance.



Question 7.3.70

If convertible debt has a fixed maturity date and a separate equity-classified component, does the fixed maturity date constitute a 'redemption date'?

Interpretive response: No.

The specific scope exception for equity components of convertible debt instruments applies to redeemable features that are not exercisable at the reporting date (see Question 7.2.80). The assessment requires the issuer to consider whether it will be required to settle the convertible debt instrument for cash or other assets at the reporting date. [480-10-S99-3A(3e)]

For these instruments, the assessment of whether the convertible debt instrument will become redeemable or convertible for cash or other assets at a future date is not made. This approach for an equity-classified component of a convertible debt instrument differs from how the temporary equity guidance applies to all other instruments in its scope. The other instruments in scope are classified as temporary equity if there is any circumstance in which the issuer does not control when cash settlement would be required.



Question 7.3.80

How is an instrument classified in a subsidiary's stand-alone financial statements if it has a cash redemption feature that the parent must settle?

Interpretive response: It depends. The subsidiary may determine that the equity-classified instrument does not contain a redemption feature for its stand-alone financial statements if:

- the subsidiary has not agreed to pay the parent back on exercise of the redemption feature; and
- the parent would legally own those instruments on the exercise of the redemption feature by the holder.

Permanent equity classification may be appropriate in this case because the subsidiary is not required to pay cash or other assets (to the holder or the parent) on exercise of the redemption feature.

In the consolidated financial statements, we believe the equity-classified instrument represents redeemable NCI. In this case, the parent combines the equity-classified instrument issued by the subsidiary and the cash redemption option it issued to the holder to form a single instrument for accounting purposes. For a discussion on redeemable NCI, see section 7.5 of KPMG Handbook, [Consolidation](#).

7.3.30 Assessing the redemption feature



Excerpt from ASC 480-10

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings
- • > SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

Classification

Examples in which temporary equity classification is appropriate

6. *Example 1.* A preferred security that is not required to be classified as a liability under other applicable GAAP may be redeemable at the option of the holder or upon the occurrence of an event that is not solely within the control of the issuer. Upon redemption (in other than a liquidation event that meets the exception in paragraph 3(f)), the issuer may have the choice to settle the redemption amount in cash or by delivery of a variable number of its own common shares with an equivalent value. For this instrument, the guidance in Section 815-40-25 should be used to evaluate whether the issuer controls the actions or events necessary to issue the maximum number of common shares that could be required to be delivered under share settlement of the contract. If the issuer does not control settlement by delivery of its own common shares (because, for example, there is no cap on the maximum number of common shares that could be potentially issuable upon redemption), cash settlement of the instrument would be presumed and the instrument would be classified as temporary equity.
7. *Example 2.* A preferred security that is not required to be classified as a liability under other applicable GAAP may have a redemption provision that states it may be called by the issuer upon an affirmative vote by the majority of its board of directors. While some might view the decision to call the security as an event that is within the control of the company because the governance structure of the company is vested with the power to avoid redemption, if the preferred security holders control a majority of the votes of the board of directors through direct representation on the board of directors or through other rights, the preferred security is

7. SEC guidance on redeemable equity-classified instruments

redeemable at the option of the holder and classification in temporary equity is required. In other words, any provision that requires approval by the board of directors cannot be assumed to be within the control of the issuer. All of the relevant facts and circumstances should be considered.

8. *Example 3.* A preferred security that is not required to be classified as a liability under other applicable GAAP may contain a deemed liquidation clause that provides that the security becomes redeemable if the common stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, common stock representing less than a majority of the voting power of the outstanding common stock of the surviving corporation. This change-in-control provision would require the preferred security to be classified in temporary equity if a purchaser could acquire a majority of the voting power of the outstanding common stock without company approval, thereby triggering redemption.
9. *Example 4.* An equity instrument may contain provisions that allow the holder to redeem the instrument for cash or other assets upon the occurrence of events that are not solely within the issuer's control. Such events may include:
 - The failure to have a registration statement declared effective by the SEC by a designated date
 - The failure to maintain compliance with debt covenants
 - The failure to achieve specified earnings targets
 - A reduction in the issuer's credit rating.

Since these events are not solely within the control of the issuer, the equity instrument is required to be classified in temporary equity.

Examples in which permanent equity classification is appropriate

10. *Example 5.* A preferred security may have a provision that the decision by the issuing company to sell all or substantially all of a company's assets and a subsequent distribution to common stockholders triggers redemption of the security. In this case, the security would be appropriately classified in permanent equity if the preferred stockholders cannot trigger or otherwise require the sale of the assets through representation on the board of directors, or through other rights, because the decision to sell all or substantially all of the issuer's assets and the distribution to common stockholders is solely within the issuer's control. In other words, if there could not be a "hostile" asset sale whereby all or substantially all of the issuer's assets are sold, and a dividend or other distribution is declared on the issuer's common stock, without the issuer's approval, then classifying the security in permanent equity would be appropriate.
11. *Example 6.* A preferred security may have a provision that provides for redemption in cash or other assets if the issuing company is merged with or consolidated into another company, and pursuant to state law, approval of the board of directors is required before any merger or consolidation can occur. In that case, assuming the preferred stockholders cannot control the vote of the board of directors through direct representation or through

7. SEC guidance on redeemable equity-classified instruments

other rights, the security would be appropriately classified in permanent equity because the decision to merge with or consolidate into another company is within the control of the issuer. Again, all of the relevant facts and circumstances should be considered when determining whether the preferred stockholders can control the vote of the board of directors.

After identifying a redemption feature of an equity-classified instrument that is in scope of the temporary equity guidance (see section 7.3.20), the issuer assesses: [480-10-S99-3A]

- whether the occurrence of an event that triggers redemption is solely in its control; and
- whether the holders of the instrument control the board of directors.

The examples in the above excerpt illustrate these assessments. Each example is explained and expanded on throughout section 7.3.

Temporary equity example	Redemption feature description	Reference
Example 1	Issuer option to pay in cash or shares on redemption	Question 7.3.150
Example 2	Instrument redeemable at the option of the issuer	Question 7.3.190
Example 3	Instrument redeemable on a change in control	Example 7.3.70
Example 4	Instrument redeemable on events outside the issuer's control	Questions 7.3.120 to 7.3.140
Example 5	Instrument redeemable on sale of assets	Example 7.3.70
Example 6	Instrument redeemable on merger	Example 7.3.70

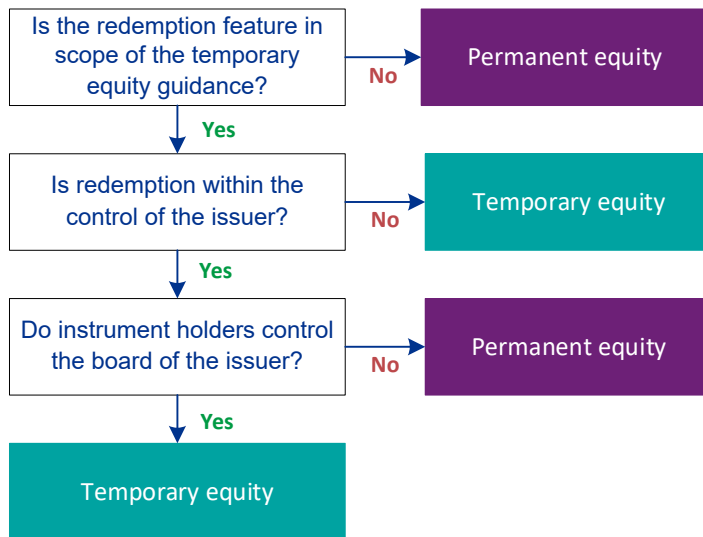


Question 7.3.90

How does an issuer assess redemption features under the temporary equity guidance?

Interpretive response: The broad outline of how an issuer assesses a redemption feature is summarized in the following decision tree.

7. SEC guidance on redeemable equity-classified instruments



Therefore, an equity-classified instrument is classified as temporary equity if the issuer does not control the events that trigger redemption or if the holders control the issuer's board of directors. However, an equity-classified instrument is classified as permanent equity if the issuer has sole control over the events that trigger redemption (see Question 7.3.100).



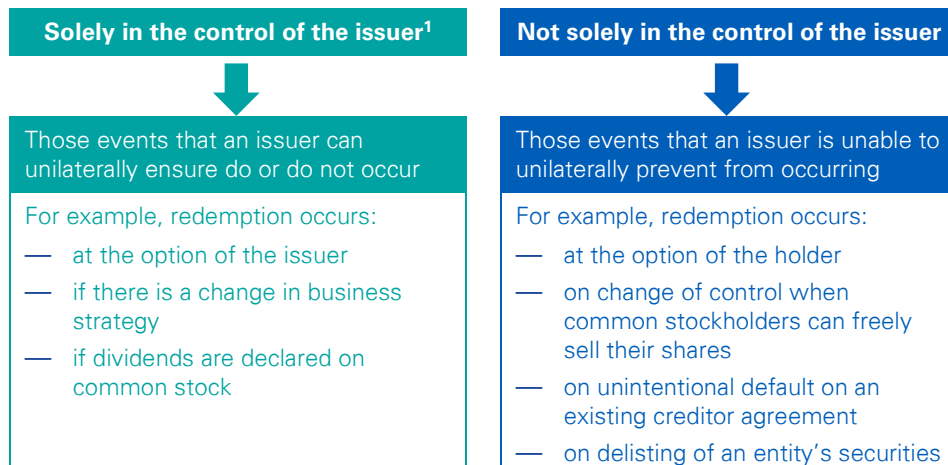
Question 7.3.100

What are examples of redemption triggers that are solely in or not in the issuer's control?

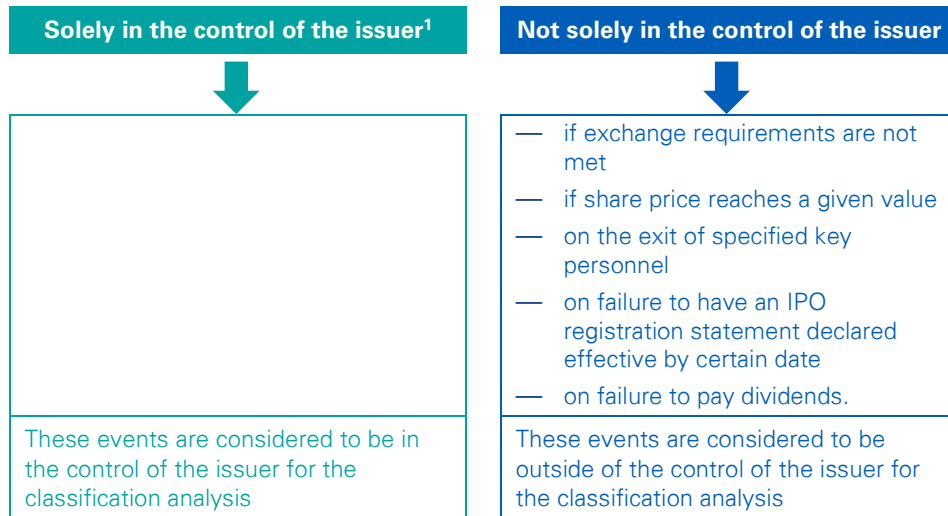
Interpretive response: The level of control of events that trigger redemption can be classified into:

- events that are solely in the control of the issuer; and
- events that are not solely in the control of the issuer.

The following summarizes examples of control.



7. SEC guidance on redeemable equity-classified instruments



Note:

1. The examples that describe complete control assume that the holders of the instrument do not control the board of directors (see Questions 7.3.180 to 7.3.220).

See Example 7.3.70 for additional scenarios that require assessment.



Question 7.3.110

Does redemption have to be in the holder's control to trigger temporary equity classification?

Interpretive response: Not necessarily. The relevant party for this assessment is the issuer; redemption only needs to be outside of the issuer's control for temporary equity classification. [480-10-S99-3A(4)]

This means that temporary equity classification may be required not only when the redemption feature is in the holder's control but also when it is triggered by some other event or condition that is outside the control of the issuer or the holder.



Question 7.3.120

How does an issuer consider a holder redemption feature that is only exercisable if it issues new equity-classified instruments?

Interpretive response: Because the redemption feature is contingent on the issuer issuing new equity-classified instruments, and that decision is in the issuer's control, the redemption feature does not result in temporary equity classification of the instrument. This conclusion applies only if the holder does not have control of the issuer (see Question 7.3.140). [480-10-S99-3A(4)]

**Question 7.3.125****How does an issuer classify shares that become redeemable by the holder if the issuer completes a merger or are redeemed on a specified date if a merger does not occur?**

Background: Certain entities (e.g. SPACs) issue shares that become redeemable if the issuer completes a merger or are redeemed on a specified date if a merger does not occur.

Interpretive response: The shares are required to be classified in temporary equity. The issuer does not control whether the shares become redeemable; rather, the shares will become redeemable by a specified date. That is, the shares will be automatically redeemed on the specified date or will become redeemable at the holder's option earlier if a merger occurs.

**Question 7.3.126****Is a redeemable share's classification impacted when there are limits on the total amount of instruments that can be redeemed?**

Background: Certain entities that issue redeemable shares have governing documents that limit the total amount of shares that can be redeemed. In our experience, a SPAC structure may include publicly held instruments that are redeemable by the holders at various times. However, the redemption right is subject to a limitation in a SPAC's governing documents that does not permit redemption if it would cause the SPAC's net tangible assets to decline below defined thresholds.

Interpretive response: No. An equity-classified instrument that could be redeemed upon the occurrence of an event outside a registrant's (issuer's) control is required to be classified in temporary equity.

Further, the SEC staff has stated that it would object to classifying any portion of such a class of instruments in permanent equity, because each share has a redemption right. [\[2021 AICPA Conf\]](#)

Question 7.4.75 discusses subsequent measurement in this situation.

**Example 7.3.25****Classification of redeemable shares with redemption subject to a minimum net tangible assets limitation**

On January 1, Year 1, SPAC issues 1 million units – with each unit comprising one Class A common share and one warrant – in an IPO for \$10 per share – i.e. total proceeds of \$10 million.

SPAC determines that the Class A common shares and warrants are both freestanding instruments and are accounted for separately. SPAC also determines that the warrants should be liability classified. The shares meet the conditions to be classified in equity – i.e. they are not liabilities under Topic 480.

The Class A common shares have the following redemption features.

- The shares will become redeemable for \$10 at the holder’s election immediately before consummation of a merger (i.e. an aggregate redemption amount of \$10 million). However, SPAC is not required to redeem shares if redemption would result in SPAC’s defined net tangible assets being less than \$5 million.
- If SPAC does not consummate a merger by December 31, Year 2 (i.e. two years after SPAC’s IPO), SPAC will liquidate and automatically redeem the Class A common shares for \$10 per share (i.e. an aggregate of \$10 million).

SPAC determines that the warrants have an aggregate fair value of \$2 million. Therefore, SPAC allocates \$2 million of the issuance proceeds to the warrants and \$8 million of the proceeds to the Class A common shares (see Example 7.4.10, Scenario 2).

On January 1, Year 1, SPAC has net tangible assets of \$8 million.

Because the Class A common shares will become redeemable (i.e. they will be redeemable on or before December 31, Year 2), temporary equity classification is required. This is the case even if redeeming all Class A shares would reduce SPAC’s net tangible assets to less than \$5 million.

Example 7.4.55 illustrates subsequent measurement.



Question 7.3.130

What is required for an event to be ‘solely in the control of the issuer’?

Interpretive response: The evaluation of whether the event is ‘solely in the control of the issuer’ is based on the relevant governance structure applicable to the issuing entity. In a typical corporate structure, individuals that are charged with governance, normally the board of directors, should be able to unilaterally prevent redemption from occurring at all times.

Generally, this level of control exists only when:

- there is an explicit requirement for board approval before redemption – e.g. a redemption clause that is at the issuer’s option;
- the initiation of the event that triggers redemption is under the absolute control of the board – e.g. redemption can only occur following a subsequent issuance of equity; or
- there is an alternative settlement option that would be consistent with permanent equity classification that gives the entity the unrestricted ability to exercise at any point in time – e.g. a conversion to shares at the entity’s option when the entity has the unrestricted ability to settle in shares and can assert share settlement.

However, there are scenarios when even this may not be sufficient, such as those discussed in Question 7.3.140.

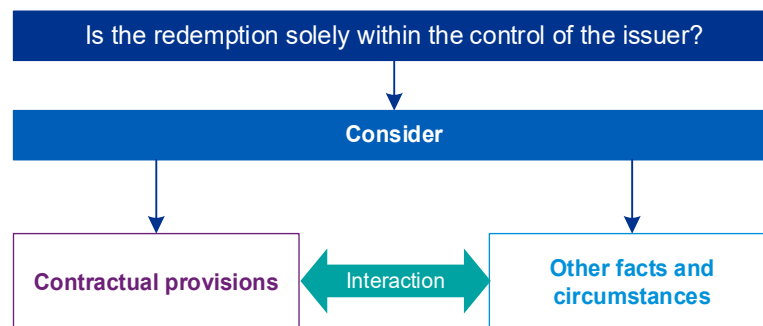


Question 7.3.140

Does the assessment of whether redemption is solely in the control of the issuer consider only the contractual terms of the instrument?

Interpretive response: No. The temporary equity guidance requires consideration of all facts and circumstances when analyzing the possibility of redemption occurring.

Therefore, even when a review of the contract reveals that there are no explicit redemption features or that the redemption features appear to be solely in the issuer's control, further consideration is appropriate to ensure that there is no set of circumstances that would trigger redemption that is not solely in the issuer's control.



Some example facts and circumstances are illustrated below.

Holders control the issuer

If holders of the instrument being evaluated control the issuer, the following are deemed to be outside of the issuer's control and result in the equity instrument being classified as temporary equity:

- issuer redemption options; and
- contingent events that would otherwise be considered to be in the issuer's control – e.g. the sale of a given value of assets.

See Question 7.3.210 for further discussion when holders control the issuer.

Redemption clause can be settled in equity at issuer's option

When a redemption clause can be settled in equity at the option of the issuer, or for conversion clauses (see section 7.3.20), the temporary equity guidance requires that the issuer's ability to settle in shares be assessed under the guidance in Section 815-40-25; see sections 8.11 and 8.12 as well as Question 7.2.91. If the issuer cannot demonstrate that it can settle in shares under all circumstances, cash settlement of the instrument is presumed and it is temporary equity-classified (see Questions 7.3.150 and 7.3.160).

7. SEC guidance on redeemable equity-classified instruments

This is consistent with SEC staff remarks in 2000, when the staff described a situation in which there are insufficient authorized shares to settle a conversion feature in a preferred security, necessitating a shareholder meeting to authorize additional shares. The staff stated that the requirement to obtain shareholder approval to authorize additional shares is outside of the issuer's control. The staff therefore would conclude that because the redemption of the preferred security for cash could be triggered by an event that is outside of the issuer's control, the preferred security should be classified outside of permanent equity (i.e. temporary equity). [2000 AICPA Conf]

Redemption clause contingent on event in issuer's control

Even if a redemption clause is contingent on an event in the issuer's control, the issuer may be committed to an action that will remove that contingency or take the contingency out of its control. If the issuer's commitment to such an action is so significant that substantively the issuer no longer has the option to avoid taking that action, then it classifies the instrument as temporary equity. It may require significant judgment for an issuer to assess its level of commitment to a particular course of action.

Federal or state law requires board approval to initiate contingent event

An equity-classified instrument is typically classified as temporary equity when it has a redemption clause contingent on an event not initiated by the issuer's board of directors. However, if federal or state law requires the board's approval of such an event (e.g. a specified corporate action such as a merger), the contingent event would effectively be brought back under the control of the board and would be considered to be solely in the issuer's control – assuming the holders of the instrument do not control the board.



Question 7.3.150

Is the probability of redemption occurring considered in the classification assessment?

Interpretive response: No. The issuer needs to be able to demonstrate a unilateral ability to control whether a redemption event occurs. Therefore, in the following scenarios, temporary equity classification is required. [480-10-S99-3A(5)]

Scenario	Temporary equity classification is required...
Redemption is at the option of the holder	Even if the holder has stated that it does not intend to exercise the option
Redemption is triggered by the occurrence of an event outside of the control of the entity	Even if the event is highly unlikely to occur
The holders are given the option to redeem on the occurrence of an event outside of the control of an entity	Even if the event is highly unlikely to occur and the holder has stated that, if the event does occur, it does not intend to exercise the option

Similarly, temporary equity classification is required when the issuer has the option to settle in shares, but the analysis under Section 815-40-25 does not demonstrate that the issuer has the unilateral ability to share-settle in all circumstances, as discussed in Question 7.3.140. For example, see section 8.12.20 for discussion on evaluating whether an entity has sufficient authorized and unissued shares. It does not matter how remote the circumstances are that could lead to a presumption of cash settlement.

In prepared remarks in 2009, the SEC staff stated: [\[2009 AICPA Conf\]](#)

“A key question in accounting for contracts on own stock and redeemable shares is whether the company can avoid settling the instrument in cash or other assets even in contingent scenarios that may be improbable... An equity share is generally presented in mezzanine temporary equity if it could require cash settlement for reasons beyond the company’s control.”



Question 7.3.160

If an issuer is able to assume share settlement of some but not all of a single class of equity-classified instruments, does it classify the entire class as temporary equity?

Background: Certain preferred shares may give the holder the right to convert to common shares. The issuer assesses its obligation to issue common shares on conversion under Section 815-40-25 to determine whether the preferred shares are temporary or permanent equity.

Interpretive response: We believe the appropriate classification depends on the issuer’s legal right to settle if all instruments in the class were converted at the same time. The accounting determination is based on the legal assessment of applicable state laws and the share agreements.

For example, an issuer is legally permitted to fully settle certain of the individual fungible preferred shares solely in common shares, and other preferred shares fully in cash on conversion. It classifies the instruments that can be settled fully in shares as permanent equity and the remaining instruments as temporary equity. This result assumes the issuer has enough authorized but unissued shares available on settlement of the instruments classified as permanent equity. See Example 7.3.30.

The result is different if there are legal restrictions whereby the issuer must settle the conversion feature of all instrument holders in the same manner (e.g. either all in common shares or all in cash). If the issuer does not have enough authorized but unissued shares available to share-settle all of the instruments, it must:

- assume all instruments will be cash-settled; and
- classify the entire class of instruments as temporary equity.

We believe the issuer should analyze whether it currently has enough authorized but unissued shares using the maximum number of shares that would be required to be issued at the conversion date.

**Example 7.3.30****Evaluating whether an issuer has sufficient authorized shares to settle mandatorily convertible preferred shares and its effect on classification**

Issuer raises additional equity through a preferred shares offering. The offering document for the preferred shares contains the following conversion provisions.

- Mandatory conversion of the securities three years from the date of issuance.
- The mandatory conversion provision will be settled through delivery of a variable number of Issuer's common shares.
- At the conversion date, the number of common shares issued on conversion is based on a formula using:
 - the then fair value of the common shares; and
 - a collar whereby the investor only participates in increases and decreases in share price above and below certain share price thresholds.

Issuer has determined that the instrument is not a liability under Topic 480 (see chapter 6) and the conversion feature is not subject to a scope exception from the temporary equity guidance (see Question 7.3.50). Therefore, it needs to assess the instrument under the temporary equity guidance.

It may appear that there is nothing in the conversion clause that would trigger temporary equity presentation because the contractual clause requires that Issuer convert the preferred shares to common shares. Further, the preferred shares are not redeemable for cash or other assets of the Issuer.

However, because redemption is required in shares, Issuer must determine if it could under all circumstances deliver the required number of shares on conversion; see section 8.11. If Issuer is unable to demonstrate this, it must classify the preferred shares as temporary equity.

In evaluating whether it will have enough authorized but unissued shares to settle the instrument, Issuer must consider the fact that it may be called on to deliver a variable number of shares at the mandatory redemption date.

We believe Issuer should analyze whether it currently has enough authorized but unissued shares using the maximum number of shares that would be required to be issued at the conversion date. Issuer should also consider all other relevant criteria in paragraphs 815-40-25-7 to 25-35 to evaluate whether there may be situations in which it cannot control share settlement, including evaluating whether it has sufficient unissued shares after considering all other instruments that could potentially require share issuance; see section 8.12 and Question 7.2.91. Only if Issuer can demonstrate the ability to share-settle on conversion in all circumstances would the mandatorily convertible preferred shares be classified as permanent equity.



Question 7.3.170

How are knock-out clauses considered in the classification analysis?

Interpretive response: If an instrument contains a redemption clause that is not yet currently exercisable, the issuer assesses all other features that could result in different forms of settlement. If the instrument contains a knock-out clause (see Question 7.2.150), the issuer determines whether it controls the event that triggers exercise of this alternative form of settlement.

Issuer conversion feature

Assume an issuer issues preferred shares with:

- a holder redemption option that is exercisable only three years after issuance; and
- an issuer conversion option to convert it to common shares that is exercisable at any time following issuance.

Because the issuer can elect to convert to common shares before the holder's right to redeem, the issuer's ability to assert share settlement of the conversion clause is an important consideration.

If the issuer cannot assert share settlement based on the guidance in Section 815-40-25 (see section 8.12 and Question 7.2.91), the issuer conversion option is considered a redemption feature and not a knock-out provision of the holder redemption option. In that case, the issuer would be required to use cash to repurchase the instrument if it decides to convert, which would necessitate classifying the instrument as temporary equity.

However, if the issuer can assert share settlement based on the guidance in Section 815-40-25, the issuer conversion option knocks out the redemption option and the instrument is classified as permanent equity.

Holder conversion feature

Assume an issuer issues preferred shares with:

- a holder redemption option that is exercisable only three years after issuance; and
- a holder conversion option to convert to common shares that is exercisable at any time.

The issuer does not consider the conversion feature to be a knock-out clause of the holder redemption option because the conversion feature is not in its control. The instrument is classified as temporary equity because of the holder redemption option.

Considerations when the holders have representation on the board of directors

To determine whether the occurrence of an event that triggers redemption of an equity-classified instrument is solely in the issuer's control, the issuer must assess whether the holders of the instrument control the issuer's board of

directors. The following questions and examples describe scenarios in which the holders may have representation on the board and how that intersects with the temporary equity guidance.



Question 7.3.180

Are contractual provisions that could transfer control over redemption away from the issuer considered at the reporting date?

Interpretive response: Yes. The assessment of whether redemption is solely in the issuer's control also considers contractual provisions in the instrument that could transfer control away from the issuer in the future. [\[480-10-S99-3A\(9\)\]](#)

For example, if a class of preferred shares contains a call option that can be exercised by the issuer, the entity must determine whether the preferred shareholders control the board of directors at the reporting date (see Question 7.3.200). Even if it is determined that they do not currently control the board, the legal documents need to be reviewed to ensure there is no clause that would enable the preferred shareholders to take control of the board on the occurrence of an event that is not in the issuer's control.

In a typical example, a class of preferred shareholders can take control of the board on failure to pay required periodic dividends on preferred shares that include a call option. On taking control, the preferred shareholders can exercise the call option. Unless there is a third provision that makes the call option inoperable when the preferred shareholders are in control, the call option functions in the same manner as a put option by the preferred shareholders. Because the issuer cannot control whether it will have sufficient cash to pay dividends, it cannot control whether the preferred shareholders will take control and exercise their call option. Therefore, redemption of the preferred shares is not solely in the issuer's control. [\[2009 AICPA Conf\]](#)



Question 7.3.190

Is temporary equity classification triggered when redemption requires the majority vote of the holders of the instrument?

Interpretive response: Yes, because how the holders of the instrument will vote is outside of the issuer's control.

This is true even when the holders of the instrument are also the controlling shareholders, members of the board of directors, those charged with governance and/or management of the issuer. The decision to vote for redemption is a right of the holder and therefore independent from, and outside of, the control of the issuer.



Question 7.3.200

What factors are considered to determine who controls an entity's board of directors?

Interpretive response: Factors that are considered to determine who controls an entity's board of directors include (not exhaustive):

- share ownership of each board member, including if they own multiple classes of equity instruments;
- whether different board members who own the same class of shares could collectively vote in their own interests to cause a redemption of their shares;
- whether board members who own different classes of shares could collectively vote in their own interests to cause a redemption of their shares; and
- board composition and other governance rules of the issuer.



Example 7.3.40

Assessment of voting interests of shareholders who are board members of the same class of instruments

Issuer has two classes of equity instruments: Series A preferred shares and common shares.

The seven-member board comprises four Series A preferred shareholders and three common shareholders.

All of the preferred shares are callable by Issuer after three years for cash.

The call option Issuer holds requires assessment to determine if the preferred shareholders control Issuer. Individually, each preferred shareholder does not control the board (each has 1/7th control). However, collectively the preferred shareholders have control of the board (4/7th control).

As discussed in Question 7.3.190, how the preferred shareholders will vote is outside Issuer's control. Therefore, the preferred shareholders control the board and the redemption of the preferred shares is not solely in Issuer's control and results in temporary equity classification and measurement.



Example 7.3.50

Assessment of voting interests of shareholders who are board members of different classes of instruments

Issuer has several classes of equity instruments (listed in order of most senior to most subordinate in liquidation):

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- Series D preferred shares
- Series C preferred shares
- Series B preferred shares
- Series A preferred shares
- common shares.

Each preferred series is owned by one investor who became a board member on initial investment. The common shareholders have three seats on the seven-member board.

All of the preferred shares are callable by Issuer after three years for cash.

The call option Issuer holds requires assessment to determine if the shareholders control Issuer. Individually, each preferred shareholder does not control the board (each has 1/7th control). However, if there is a scenario in which all of the preferred shareholders will vote together because their economic interests are aligned and do not conflict, that scenario triggers temporary equity classification for all series of the preferred shares. Temporary equity classification is triggered in that case because redemption is not solely within Issuer's control (the preferred shareholders have 4/7th control).

To determine if such a scenario exists, Issuer considers:

- if there is sufficient excess cash for all of the preferred shareholders to be paid out on redemption;
- economic incentives of each holder; and
- dividend rights and liquidation preferences of each class.



Question 7.3.210

How are independent directors considered when assessing whether a redemption event is in the issuer's control?

Interpretive response: If an instrument is redeemable at the issuer's option, the issuer evaluates whether the holders control the board of directors such that the redemption may not be entirely in the issuer's control. [480-10-S99-3A(7)]

To do this, the issuer evaluates each class of shareholders to determine:

- if any of the class of shareholders (either individually or collectively) controls the board; and
- who appointed the other board members (or has the right to appoint/dismiss/reappoint the other board members), even if those board members are deemed 'independent' for certain legal and regulatory purposes.

The term 'independent director' could have different meanings, depending on the context. For example, there are NYSE and NASDAQ regulations that define the 'independent director' in regard to the composition of the board of directors, as well as state regulations that focus on an independent director's fiduciary duties.

While a board member may meet the definition of an independent director for one or more other purposes, based on discussions with the SEC staff, we believe a director could be viewed as not independent based on:

- how (and by whom) the director was nominated to the board; and
- how the director could be removed from the board (including who controls the replacement of that director).



Question 7.3.215**

How are independent directors considered when appointment is mutually determined by board members who are common and preferred shareholders?

Interpretive response: When board composition is equally balanced among members who are (and are elected by) preferred and common shareholders and independent directors are to be mutually appointed and replaced by the remaining preferred and common shareholders who are members of the board, generally the preferred shareholders are still presumed to have control over the appointment (and replacement) of independent directors.

Based on discussions with the SEC staff, we believe that even when appointment/replacement of independent directors is to be mutually agreed upon by the remaining board members, when the preferred and common shareholder board seats are equally balanced, the preferred shareholders will be economically compelled to reject any independent directors put forth by the common shareholder board members if not aligned with the interests of the preferred shareholders. Said differently, there is a presumption that the preferred shareholder board members would exercise their ability to vote against any proposed independent board members until an independent board member of their preference is identified and appointed.



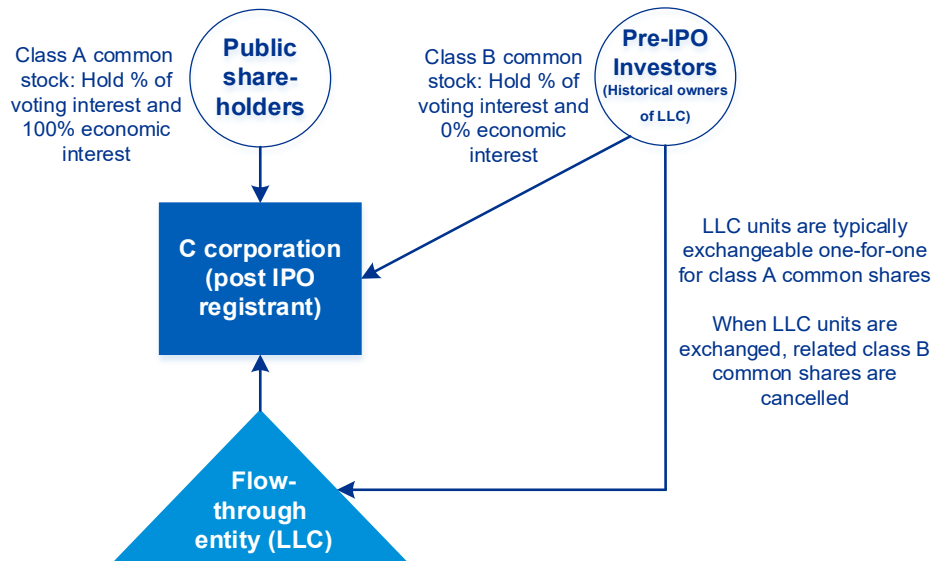
Example 7.3.60

Assessment of voting interests of independent directors in an Up-C structure

Umbrella partnership C corporation (Up-C) structures allow owners of a flow-through entity (e.g. a limited liability corporation (LLC)) to conduct an IPO via a newly formed C corporation (that will be the registrant).

7. SEC guidance on redeemable equity-classified instruments

The following depicts the general organization in an Up-C structure in an IPO.



C-Corp consolidates the LLC and reports the LLC units it does not own as NCI.

LLC Units and the Class B common shares, typically held by the pre-IPO investors, have substantial restrictions on transferability. However, the pre-IPO investors typically have the right to exchange one LLC unit along with one C-Corp Class B common share for one C-Corp Class A common share. In the event the pre-IPO investors wish to undertake this exchange, C-Corp, at its election, may choose to settle such exchange in cash that is typically based on the fair value of the C-Corp Class A common shares at the time of such exchange.

Scenario 1: Cash redemption feature is in the control of the Class B common shareholders

The board comprises seven members, all appointed by the Class B common shareholders before the IPO.

- Four board members are Class B common shareholders.
- The other three board members, two of whom are considered independent under the relevant stock exchange rules, hold only Class A common shares.

The governing documents of C-Corp indicate that only independent members of the board are permitted to vote when an LLC unit and a Class B common share in C-Corp are submitted for exchange – i.e. only the independent board members can decide if the exchange is done physically for a Class A common share or for cash.

Analyzing board control

In its consolidated financial statements, C-Corp generally presents the pre-IPO investors' retained LLC unit interests as NCI. However, the terms of the LLC units held by the pre-IPO investors are evaluated for cash redemption features to determine if the NCI must be classified as temporary equity or permanent equity. Further, who controls the cash redemption option is analyzed.

In this scenario, the independent board members of C-Corp have the ability to control cash redemption. Based on informal conversations with the SEC staff, we believe that if the Class B common shareholders appointed the independent directors and the Class B common shareholders also currently control the board, the cash redemption feature is in the control of the Class B common shareholders. If this is the case, the temporary equity guidance must be applied.

Our view is based on the fact that four of the seven board members, comprising more than 50% of the board, hold the Class B common shares. Therefore, those four Class B shareholders are deemed to control the board's redemption decision because they could replace (or not renominate) the independent directors if they did not vote in accordance with the Class B common shareholders' preferences.

In subsequent evaluations, we believe all facts and circumstances of the board's governance process should be considered to determine when and if reclassification to permanent equity is appropriate. This includes the length of board terms, the relative holdings of Class B holders, the public and board nomination process, and the ongoing magnitude of Class B holdings by the original investors.

For example, ratification of independent board members by the common shareholders of C-Corp – who hold a majority of the voting interests of C-Corp but who do not hold any Class B common shares – might be a positive indicator of a board member's independence for purposes of determining the appropriate classification of the NCI.

Similarly, a change in board members or board member ownership such that 50% or more of the board members do not hold Class B common shares would be persuasive evidence of the board members' independence for purposes of determining the appropriate classification of the NCI.

However, the fact that exchanges of LLC units for Class A shares have occurred without using cash would not, in and of itself, be a relevant indicator of intent that would be sufficient to justify reclassification.

Further, when NCI holders are otherwise determined to control the board, we believe that the establishment of a separate committee of the board to exercise full control over all decisions on settlement of noncontrolling interest redemptions is not a determinative factor for permanent equity classification even if the committee:

- has full delegated power from the board regarding such settlement decisions; and
- comprises directors that are neither nominated by nor affiliated with any NCI holder.

Scenario 2: Cash redemption feature is *not* in the control of the Class B common shareholders

Assume the same facts as in Scenario 1, except that the settlement terms specify that if the board decides to settle the exchange of LLC units and Class B shares in cash, only the cash available from a new future equity offering that will be classified in permanent equity under US GAAP can be used.

While the analysis of board control is the same as in Scenario 1, we believe because the funds used to settle if the cash settlement option is used would only be available from a new permanent equity-classified issuance (and not from available cash on hand or through the establishment of a new liability), the feature would not trigger temporary equity classification.



Question 7.3.220

Does a power held by a holder to contractually alter an instrument affect whether the issuer has sole control over the instrument's redemption?

Interpretive response: No. Unlike Question 7.3.170 (where the contractual provision is already in the instrument), when an instrument holder controls the issuer, we do not believe that its power to modify the contractual terms of that instrument should be considered in determining whether the issuer has sole control over the instrument's redemption.

For example, if an instrument has no redemption features, it will be classified as permanent equity even if the holders control the issuer and could use their power over the entity to modify the contractual terms of that instrument so that it becomes redeemable – e.g. by adding a cash redemption feature.

7.3.40 Deemed liquidation clauses

Under a deemed liquidation clause, all or some equity holders are either required, or are given the option, to exchange their equity instruments for cash or other assets on the occurrence of a deemed liquidation event. Therefore, a deemed liquidation clause has the general characteristics of a redemption feature as set out in section 7.3.20.

Examples of deemed liquidation events are a change in control of the issuer that does not result in the issuer's termination or liquidation, violation of a debt covenant, or delisting of the issuer's securities from an exchange.



Question 7.3.230#

Do deemed liquidation clauses result in temporary equity classification?

Interpretive response: It depends. A deemed liquidation clause results in temporary equity classification unless the events that could trigger the clause are solely within the issuer's control or a specific exception is met. [\[480-10-S99-3A\(3f\)\]](#)

There is a narrow and limited exception to temporary equity classification for clauses characterized as liquidation provisions, but those clauses are triggered by something other than the ordinary liquidation of the issuer. Under this exception, a deemed liquidation clause does not trigger temporary equity

classification if all holders of equally and more subordinated equity instruments would: [480-10-S99-3A(3f)]

- also be entitled to redeem (condition 1); and
- on redemption, receive the same form of consideration (condition 2).

While the first condition is an objective determination, determining whether the second condition is met may require judgment (see Question 7.3.250). To appropriately assess the second condition, an issuer evaluates other instruments to determine how the terms of those instruments can affect the assessment, and what form of consideration the other instruments offer on redemption (see Example 7.3.80).

See SEC Examples 3, 5 and 6 in paragraphs 480-10-S99-3A(8), (10) and (11) respectively – reproduced in section 7.3.30. [480-10-S99-3A(3f)]

When an event that could trigger the clause is traditionally within the issuer's control but the preferred shareholders control the board of directors, such an event should be evaluated to determine if it is now within the control of the holder. If within control of the holder, the limited scope exception to temporary equity classification is not applied.



Example 7.3.70 Deemed liquidation clauses

Scenario 1: Preferred shareholders do not control the board of directors

Issuer was incorporated with only common shares outstanding and subsequently raises additional equity through a preferred share offering. The preferred shareholders do not control Issuer's board.

The offering document for the preferred shares contains the following clause.

- In the event of the occurrence of any of the following Fundamental Transactions, the preferred shares will be immediately redeemed and settled in cash at their 'liquidation value', which is equal to the proceeds received on the:
 - sale of fixed assets with a total book value of greater than \$10 million;
 - issuance of securities with proceeds greater than \$20 million; or
 - merger with another entity (excluding a hostile takeover).

The following additional facts are relevant.

- Issuer's common shares do not contain any clauses that would allow for redemption in any circumstances except the ordinary liquidation of Issuer.
- In the ordinary liquidation of Issuer, the common shareholders are subordinate to the preferred shareholders in the distribution of net assets.
- In the state in which Issuer is incorporated, mergers must be approved by the board.

Question 7.3.230 explains the deemed liquidation exception, which allows permanent equity classification for a particular class of instrument (i.e. the preferred shares in this scenario) if all shareholders of equal or more subordinated instruments receive the same form of consideration. That

7. SEC guidance on redeemable equity-classified instruments

exception is not met in this scenario because Issuer's common shareholders cannot redeem and receive cash in the event of a fundamental transaction while the preferred shareholders can.

Even though the deemed liquidation exception to temporary equity classification does not apply, the preferred shares are still classified as permanent equity. This is because the fundamental transactions would either require board approval or be subject to board veto, meaning they are in the control of the board. Because the preferred shareholders do not control the board, the redemption of the preferred shares is solely in Issuer's control and therefore the preferred shares are classified as permanent equity.

Scenario 2: Preferred shareholders control the board of directors

Assume the same facts as in Scenario 1, except that the preferred shareholders control the board.

As in Scenario 1, the preferred shares do not meet the deemed liquidation exception to be eligible for permanent equity classification and the fundamental transactions are in the board's control.

However, in this scenario, the preferred shareholders control the board; therefore, they are in a position to trigger the occurrence of a fundamental transaction – e.g. by requiring that management sell fixed assets with a value greater than \$10 million. This means that redemption is not in Issuer's control and therefore the preferred shares are classified as temporary equity.

Scenario 3: Redemption outside Issuer's control

Assume the same facts as in Scenario 1, except that there are additional fundamental transactions as follows.

- In the event of the occurrence of any of the following Fundamental Transactions, the preferred shares will be immediately redeemed and settled in cash at their par value:
 - change in control through the sale of more than 50% of common shares;
 - merger or consolidation of the entity into another entity;
 - delisting of the issuer's securities; or
 - material default under an outstanding borrowing (as defined in the legal documentation for the loan).

As in Scenario 1, the preferred shares do not meet the deemed liquidation exception to be eligible for permanent equity classification. However, to determine whether redemption is in Issuer's control, further analysis is required for the additional fundamental transactions as follows.

Fundamental transaction	Analysis
Change in control through the sale of > 50% of common shares	The board does not have any control over whether a third party offers to purchase shares from the shareholders (e.g. a hostile takeover bid), and generally the board is unable to control whether the common shareholders decide to sell to the third party.

7. SEC guidance on redeemable equity-classified instruments

Fundamental transaction	Analysis
Merger or consolidation of the entity into another entity	Because the applicable state laws require that the board approves any merger, the board is able to control this event.
Delisting of the issuer's securities	The board can make its best efforts to avoid any event that may lead to a delisting; however, exchanges generally have some requirements, and the board does not have the unilateral power to ensure that they are met. Ultimately, the delisting decision is taken by the exchange and/or exchange regulator and is therefore outside of the board's control.
Material default under an outstanding borrowing (as defined in the legal loan documentation)	The board can make its best efforts to ensure that all obligations are paid on a timely basis and all other covenants are complied with. However, ultimately whether Issuer has sufficient liquidity to pay its obligations and meet some types of covenants (e.g. debt to EBITDA ratio) is outside of the board's control.

The preferred shares are classified as temporary equity because:

- at least one of the four fundamental transactions that trigger redemption of the preferred shares is outside of Issuer's control; and
- the deemed liquidation exception is not met in this scenario.

Scenario 4: Deemed liquidation exception met

Assume the same facts as in Scenario 3, except that Issuer's common shares contain a clause that gives the common shareholders the option to put common shares to Issuer for cash at their liquidation value on the occurrence of the same fundamental transactions as specified for the preferred shares.

In this scenario, the common shareholders (who are subordinate to the preferred shareholders) have the right to redeem on the occurrence of those same deemed liquidation events that trigger redemption of the preferred shares. Because the common shareholders will receive the same form of consideration (i.e. cash), the criteria for the deemed liquidation exception are met (see section 7.3.40) and the preferred shares are classified as permanent equity.

Scenario 5: Change of control

Issuer has common and preferred shares listed on the NASDAQ. Management owns 40% of Issuer common shares with non-affiliates owning the remaining shares.

The preferred shares are redeemable at Issuer's option unless an anti-takeover provision included in the preferred shares agreement is triggered by a change of control in Issuer. On a change of control, which is defined in the preferred share agreement as an acquisition of 50% of the outstanding common shares or a business combination in which Issuer is acquired, the redemption feature of the

preferred shares becomes mandatory. Therefore, if there is a change of control, Issuer is obligated to redeem the preferred shares.

Because 60% of the voting common shares are registered and tradable in the open market, it is possible that a change of control of Issuer can occur. Therefore, because the anti-takeover provision provides for a mandatory redemption of the preferred shares on a change of control, and the triggering of that provision is outside of Issuer's control, Issuer classifies the preferred shares as temporary equity.



Question 7.3.240

Is the preferred shareholders' ability to obtain control of the board by acquiring a controlling stake in issuer's common shares relevant?

Interpretive response: No. It is not necessary to consider whether holders of equity-classified redeemable preferred shares could take control of the board by purchasing common shares or other securities. Such a view would require all equity securities with any redemption feature (conditional or otherwise) to be classified as temporary equity.

However, as described in Question 7.3.180, temporary equity classification is required if the holders of the preferred shares can control the vote of the board through direct representation or other contractual rights that arise from the preferred share instrument. An example of a right arising from the preferred share instrument is the preferred shareholders' ability to take control of the board if the issuer fails to timely pay dividends. [\[2009 AICPA Conf\]](#)



Question 7.3.250

How is the requirement that holders of equally and more subordinated equity instruments receive the 'same form of consideration' applied?

Interpretive response: We believe the evaluation of whether the equity holders would receive the same form of consideration should be based on the stated terms of the relevant legal agreements, the entity's corporate governance documents and applicable laws and regulations, as well as the facts and circumstances that trigger the liquidation.

To qualify for the limited exception, it is not required that all holders of equally and more subordinated equity instruments would receive an equal amount of consideration. It would be acceptable for the equity holders to receive different amounts of the same form of consideration, in accordance with a predetermined waterfall contained in the entity's governing documents – e.g. the entity's articles of incorporation.

However, it is only required that all equity holders are given the same settlement options, not that they all opt to receive the same consideration at final settlement. Therefore, this requirement can be met even if equity holders

are given a choice of what form the consideration will take – e.g. in cash or distribution in-kind.



Example 7.3.80

Form of consideration specified in legal agreements only for some equity instruments

Issuer has three classes of equity instruments (listed in order of most senior to most subordinate in liquidation):

- Series B preferred shares
- Series A preferred shares
- common shares.

The relevant legal agreements state that on a deemed liquidation event, the Series B preferred shareholders would first be entitled to a \$1 per share cash liquidation preference. Then any remaining net assets of Issuer would be distributed to the Series A preferred shareholders and the common shareholders in accordance with the waterfall provided in Issuer's articles of incorporation.

The Series B preferred shares do not qualify for the deemed liquidation exception because the relevant legal agreements specify that the Series B preferred shareholders would receive cash – i.e. the \$1 per share cash liquidation preference. However, the form of consideration to be received by the Series A preferred shareholders and the common shareholders is not specified in the relevant legal agreements. Therefore, the Series B preferred shares are classified as temporary equity.

However, because the temporary equity guidance is evaluated for each class of equity instruments, the Series A preferred shares and the common shares may qualify for permanent equity classification. This is because all of the holders of equally and more subordinated equity instruments would receive the same form of consideration – i.e. unspecified net assets in accordance with the waterfall.

7.4 Measurement

7.4.10 Overview



Excerpt from SAB Topic 3.C

Redeemable Preferred Stock

Facts: Rule 5-02.27 of Regulation S-X states that redeemable preferred stocks are not to be included in amounts reported as stockholders' equity, and that their redemption amounts are to be shown on the face of the balance sheet. However, the Commission's rules and regulations do not address the carrying

amount at which redeemable preferred stock should be reported, or how changes in its carrying amount should be treated in calculations of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends.

Question 1: How should the carrying amount of redeemable preferred stock be determined?

Interpretive Response: The initial carrying amount of redeemable preferred stock should be its fair value at date of issue. Where fair value at date of issue is less than the mandatory redemption amount, the carrying amount shall be increased by periodic accretions, using the interest method, so that the carrying amount will equal the mandatory redemption amount at the mandatory redemption date. The carrying amount shall be further periodically increased by amounts representing dividends not currently declared or paid, but which will be payable under the mandatory redemption features, or for which ultimate payment is not solely within the control of the registrant (e. g., dividends that will be payable out of future earnings). Each type of increase in carrying amount shall be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital.

The accounting described in the preceding paragraph would apply irrespective of whether the redeemable preferred stock may be voluntarily redeemed by the issuer prior to the mandatory redemption date, or whether it may be converted into another class of securities by the holder. Companies also should consider the guidance in FASB ASC paragraph 480-10-S99-3A (Distinguishing Liabilities from Equity Topic).

Instruments classified as temporary equity are initially measured at fair value or, where applicable, allocated proceeds (the initial amount recognized). Certain exceptions exist for:

- share-based payment awards;
- ESOPs;
- equity-classified components of convertible debt instruments; and
- NCI (see section 7.5 of KPMG Handbook, [Consolidation](#)).

The subsequent measurement requirements for instruments classified as temporary equity are intended to ensure that their measurement amount reflects the cash that would be required to be paid to the instrument's holder in a redemption by the time the holder has the right to redeem. [\[480-10-S99-3A\(12\)\]](#)

See sections 7.4.20 and 7.4.30 for the initial measurement requirements and sections 7.4.40 and 7.4.50 for the subsequent measurement requirements.

7.4.20 Initial measurement



Excerpt from ASC 480-10

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings

• • > SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

Measurement

12. *Initial measurement.* The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: ^{FN12}

FN12 SAB Topic 3C, *Redeemable Preferred Stock*, states that the initial carrying amount of redeemable preferred stock should be its fair value at date of issue. The SEC staff believes this guidance should also be applied to other similar redeemable equity instruments. Consistent with Paragraph 820-10-30-3, the transaction price will generally represent the initial fair value of the equity instrument when the issuance occurs in an arm's-length transaction with an unrelated party and there are no other unstated rights or privileges.

- a. For share-based payment arrangements with employees, the initial amount presented in temporary equity should be based on the redemption provisions of the instrument and the proportion of consideration received in the form of employee services at initial recognition. For example, upon issuance of a fully vested option that allows the holder to put the option back to the issuer at its intrinsic value upon a change in control, an amount representing the intrinsic value of the option at the date of issuance should be presented in temporary equity.
- b. For employee stock ownership plans where the cash redemption obligation relates only to a market value guarantee feature, the registrant may elect as an accounting policy to present in temporary equity either (i) the entire guaranteed market value amount of the equity securities or (ii) the maximum cash obligation based on the fair value of the underlying equity securities at the balance sheet date....
- d. For convertible debt instruments that contain a separately classified equity component, an amount should initially be presented in temporary equity only if the instrument is currently redeemable or convertible at the issuance date for cash or other assets (see paragraph 3(e)). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion at the issuance date over (2) the carrying amount of the liability-classified component of the convertible debt instrument at the issuance date.
- e. For host equity contracts (see paragraph 3(b)), the initial amount presented in temporary equity should be the initial carrying amount of the host contract pursuant to Section 815-15-30. Similarly, the initial amount presented in temporary equity for a preferred stock instrument that contains a beneficial conversion feature or is issued with other instruments should be the amount allocated to the instrument in its entirety pursuant to Subtopic 470-20 less any beneficial conversion feature recorded at the issuance date.

- > Comments Made by SEC Observer at EITF Meetings

- • > SEC Observer Comment: Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan

S99-4 The following is the text of SEC Observer Comment: Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan.

ASR 268 (see also paragraph 480-10-S99-3A) requires that to the extent that there are conditions (regardless of their probability of occurrence) whereby holders of equity securities may demand cash in exchange for their securities, the sponsor must reflect the maximum possible cash obligation related to those securities outside of permanent equity. Thus, securities held by an ESOP (whether or not allocated) must be reported outside of permanent equity if by their terms they can be put to the sponsor for cash. With respect to ESOP securities where the cash obligation relates only to market value guarantee features, the SEC staff would not object to registrants only classifying outside of permanent equity an amount that represents the maximum cash obligation of the sponsor based on market prices of the underlying security as of the reporting date; accordingly, reclassifications of equity amounts would be required based on the market values of the underlying security. Alternatively, the SEC staff would not object to classifying the entire guaranteed value amount outside of permanent equity due to the uncertainty of the ultimate cash obligation because of a possible market value decline in the underlying security.

The temporary equity guidance contains general principles for initial measurement and also exceptions for specific instruments (see section 7.4.30).

The general initial measurement principle is that instruments classified as temporary equity are initially recognized at fair value (generally equal to the proceeds received by the issuer). However, in certain situations, the amount initially recognized is an allocated value – e.g. when an equity-classified instrument is issued with another freestanding financial instrument (see Example 7.4.10). [480-10-S99-3A(12)]



Example 7.4.10

Initial measurement of redeemable preferred shares issued with warrants that are legally detachable and separately exercisable

Issuer issues preferred shares bundled with legally detachable and separately exercisable warrants to purchase common shares for total proceeds of \$50 million. The only redemption clause in the preferred shares is that holders can redeem the preferred shares at their fair value at any date.

Because the preferred shares are redeemable at any date at the holders' option, they must be classified as temporary equity. The fair value of the preferred shares on a stand-alone basis is \$48 million.

Scenario 1: Issuer has sufficient authorized and unissued shares to settle instrument

The warrants are exercisable for a fixed quantity of common shares at a fixed price. Further, as required by Subtopic 815-40 (see section 8.12.20), Issuer has demonstrated that it has sufficient authorized and unissued common shares to share-settle the instrument. The fair value of the warrants on a stand-alone basis is \$4 million.

Assuming all other criteria in Subtopic 815-40 are met, the warrants are classified as permanent equity. Therefore, by analogy to paragraph 470-20-25-2, Issuer allocates the proceeds to the warrants and the preferred shares on a relative fair value basis (see section 8.13.30) as follows.

	<i>Debit</i>	<i>Credit</i>
Cash	50,000,000	
Permanent equity (warrants) ¹		3,800,000
Temporary equity (preferred shares) ²		46,200,000
<i>To recognize proceeds received and issuance of preferred shares and warrants.</i>		
Notes:		
1. \$4 million × (50 ÷ (48+4)).		
2. \$48 million × (50 ÷ (48+4)).		

Scenario 2: Issuer does not have sufficient authorized and unissued shares to settle instrument

Assume the same facts as in Scenario 1, except Issuer has already issued all of its authorized common shares and so is unable to demonstrate that it is capable of settling the warrant in shares under the criteria specified in Subtopic 815-40.

The warrants fail to meet all the requirements in Subtopic 815-40 for equity classification. Therefore, the warrants are classified as a liability on issuance and are recognized at fair value with the residual amount allocated to the preferred shares as follows.

	<i>Debit</i>	<i>Credit</i>
Cash	50,000,000	
Warrant liability		4,000,000
Temporary equity (preferred shares) ¹		46,000,000
<i>To recognize proceeds received and issuance of preferred shares and warrants.</i>		
Note:		
1. \$50 million – \$4 million.		



Question 7.4.05

How are costs related to instruments classified as temporary equity accounted for?

Interpretive response: An issuer records specific incremental costs directly attributable to issuing instruments classified as temporary equity against the proceeds of that issuance. Internal costs related to the issuance are expensed as incurred.

Issuance costs recorded against the issuance proceeds are included in the instrument's initial carrying amount. As a result, they impact amounts subsequently recognized if the issuer is required to subsequently remeasure the instrument (see Question 7.4.10).



Question 7.4.06

How are issuance costs related to preferred shares classified as temporary equity issued with detachable stock purchase warrants accounted for?

Interpretive response: There is no specific guidance that addresses allocating issuance costs between the instruments.

If evidence suggests that individual costs were incurred specifically for the preferred shares or the warrants, we believe the issuer should allocate the specific costs to the respective components.

Otherwise, the following methods are generally used in practice:

- allocating an amount to the preferred shares component comparable to costs for issuing stand-alone preferred shares – with the residual being allocated to the warrants component;
- allocating an amount to the warrants component comparable to costs for issuing stand-alone warrants – with the residual being allocated to the preferred shares component; or
- allocating costs between the preferred shares and warrants components in proportion to the allocation of the issuance proceeds (see Example 7.4.10).

Generally, issuance costs allocated to a component are reported as a reduction of the related issuance proceeds (see Questions 7.4.05 and 5.10.30). However, if the warrants are subsequently measured at fair value (e.g. under Subtopic 815-40), we believe any allocated issuance costs should be expensed.

**Example 7.4.15****Issuance costs related to issuing redeemable preferred shares with freestanding warrants**

Assume the same facts as in Example 7.4.10, except that Issuer incurs direct offering issuance costs of \$500,000 of underwriter's fees, attorney fees, accountant fees and printing costs. In that example, the fair value of the preferred shares on a stand-alone basis is \$48 million and the fair value of the warrants on a stand-alone basis is \$4 million. Issuer elects to allocate costs between the preferred shares and warrants in proportion to the allocation of issuance proceeds (see Question 7.4.06).

Scenario 1: Issuer has sufficient authorized and unissued shares to settle warrants

Assume the same facts as in Scenario 1 of Example 7.4.10 – i.e. the warrants are classified as permanent equity. Further, total proceeds received for the issuance of the preferred shares and warrants of \$50 million are allocated between the two instruments based on their relative fair values. Therefore, Issuer also allocates costs between the preferred shares and warrants on a relative fair value basis.

Issuer records the following journal entry at issuance.

	<i>Debit</i>	<i>Credit</i>
Temporary equity – preferred shares (discount for issuance costs) ¹	461,538	
Permanent equity – APIC (warrants) ²	38,462	
Cash		500,000
<i>To recognize costs related to issuance of preferred shares and warrants.</i>		
Notes:		
1. $\$500,000 \times (\$48 \text{ million} \div (\$48 \text{ million} + \$4 \text{ million}))$.		
2. $\$500,000 \times (\$4 \text{ million} \div (\$48 \text{ million} + \$4 \text{ million}))$.		

Scenario 2: Issuer does not have sufficient authorized and unissued shares to settle warrants

Assume the same facts as in Scenario 2 of Example 7.4.10 – i.e. the warrants are liability-classified. Further, Issuer allocates \$4 million of the \$50 million issuance proceeds to the warrants based on their fair value and the residual proceeds of \$46 million (\$50 million less \$4 million) to the preferred shares. Issuer also allocates costs between the preferred shares and warrants in proportion to that allocation of proceeds.

7. SEC guidance on redeemable equity-classified instruments

Issuer records the following journal entry at issuance.

	<i>Debit</i>	<i>Credit</i>
Temporary equity – preferred shares (discount for issuance costs) ¹	460,000	
Expense ²	40,000	
Cash		500,000
<i>To recognize costs related to issuance of preferred shares and warrants.</i>		
Notes:		
1. $\$500,000 \times (\$46 \text{ million} \div (\$46 \text{ million} + \$4 \text{ million}))$.		
2. $\$500,000 \times (\$4 \text{ million} \div (\$46 \text{ million} + \$4 \text{ million}))$.		

7.4.30 Initial measurement exceptions

The exceptions to the general initial measurement guidance are for specific instruments.

Instrument	Initial measurement
Equity-classified components of convertible debt instruments – e.g. substantial premium [480-10-S99-3A(12d)]	<p>The temporary equity guidance requires that the sum of the amount recognized as a liability and the amount recognized as temporary equity equal the redemption amount (i.e. the potential cash payment), but only if the instrument is redeemable or convertible to cash at the reporting date.</p> <p>Therefore, the portion of the equity-classified component recognized in temporary equity is the excess of the redemption amount over the carrying amount of the liability component of the convertible instrument.</p> <ul style="list-style-type: none"> — The redemption amount is calculated as the greater of: <ul style="list-style-type: none"> – the cash that would need to be paid (e.g. the redemption amount) if the convertible debt instrument is redeemable at the reporting date; and – the cash that would be provided to the holder on conversion if the convertible debt instrument is convertible at the reporting date. — The carrying amount of the liability component of the convertible instrument is the amount reported as debt, including unamortized discounts, premiums and issuance costs, adjusted for any embedded features separated from the convertible debt that are accounted for as an asset or liability. <p>The calculation to determine the amount to allocate to temporary equity is performed before any adjustments are made for related tax effects of the book and tax basis difference of the debt. This is because the deferred tax liability does not affect the amount payable to the holder of</p>

7. SEC guidance on redeemable equity-classified instruments

Instrument	Initial measurement
	the instrument on redemption. See KPMG Handbook, Accounting for income taxes , for guidance on recording the tax effect of convertible instruments, including paragraphs 2.106 – 2.110, 9.057 and 9.069.
Share-based payment awards [480-10-S99-3A(12a)]	<p>The amount recognized in temporary equity is the redemption amount (calculated based on the redemption terms of the instrument) multiplied by the proportion of the total service under the arrangement that has been provided by the employee as of the grant date.</p> <p>Unless some of the equity-classified instruments granted are already fully or partially vested, this will result in an initial measurement of zero.</p> <p>For further discussion on the initial measurement of temporary equity-classified instruments issued in a share-based payment arrangement, see KPMG Handbook, Share-based payment.</p>
ESOPs [480-10-S99-3A(12b)]	<p>When the cash redemption obligation relates only to a guaranteed price given for the securities held (a 'market value guarantee feature'), the issuer makes an accounting policy choice to recognize in temporary equity either:</p> <ul style="list-style-type: none"> — the entire guaranteed market value of the securities; or — the maximum cash obligation based on the fair value of the securities at the reporting date – i.e. the excess of guaranteed value over the fair value of the securities.
NCI	See section 7.5 of KPMG Handbook, Consolidation .

7.4.40 Subsequent measurement



Excerpt from ASC 480-10

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings
- • > SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

Measurement

13. *Subsequent measurement.* The SEC staff's views regarding the subsequent measurement of a redeemable equity instrument that is subject to ASR 268 are included in paragraphs 14–16. Paragraphs 14 and 15 discuss the general views regarding subsequent measurement. Paragraph 16 discusses the application of those general views in the context of certain types of redeemable equity instruments.

14. If an equity instrument subject to ASR 268 is currently redeemable (for example, at the option of the holder), it should be adjusted to its maximum redemption amount at the balance sheet date. If the maximum redemption amount is contingent on an index or other similar variable (for example, the fair value of the equity instrument at the redemption date or a measure based on historical EBITDA), the amount presented in temporary equity should be calculated based on the conditions that exist as of the balance sheet date (for example, the current fair value of the equity instrument or the most recent EBITDA measure). The redemption amount at each balance sheet date should also include amounts representing dividends not currently declared or paid but which will be payable under the redemption features or for which ultimate payment is not solely within the control of the registrant (for example, dividends that will be payable out of future earnings). ^{FN13}

FN13 See also Section 260-10-45.

15. If an equity instrument subject to ASR 268 is not currently redeemable (for example, a contingency has not been met), subsequent adjustment of the amount presented in temporary equity is unnecessary if it is not probable that the instrument will become redeemable. If it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), the SEC staff will not object to either of the following measurement methods provided the method is applied consistently:
- Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the instrument will become redeemable, if later) to the earliest redemption date of the instrument using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates.
 - Recognize changes in the redemption value (for example, fair value) immediately as they occur and adjust the carrying amount of the instrument to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the instrument.

...

17. *Application of the fair value option.* Measurement of a redeemable equity instrument (or host contract) subject to ASR 268 at fair value through earnings in lieu of the measurement guidance provided in paragraphs 14–16 is not appropriate. ^{FN16}

FN16 Paragraph 825-10-15-5(f) prohibits the election of the fair value option for financial instruments that are, in whole or in part, classified in stockholder's equity (including temporary equity).

The subsequent measurement of an instrument classified as temporary equity generally depends on whether: [\[480-10-S99-3A\(14-15\)\]](#)

- it is currently redeemable; or
- if it is not currently redeemable, it is probable that it will become redeemable.

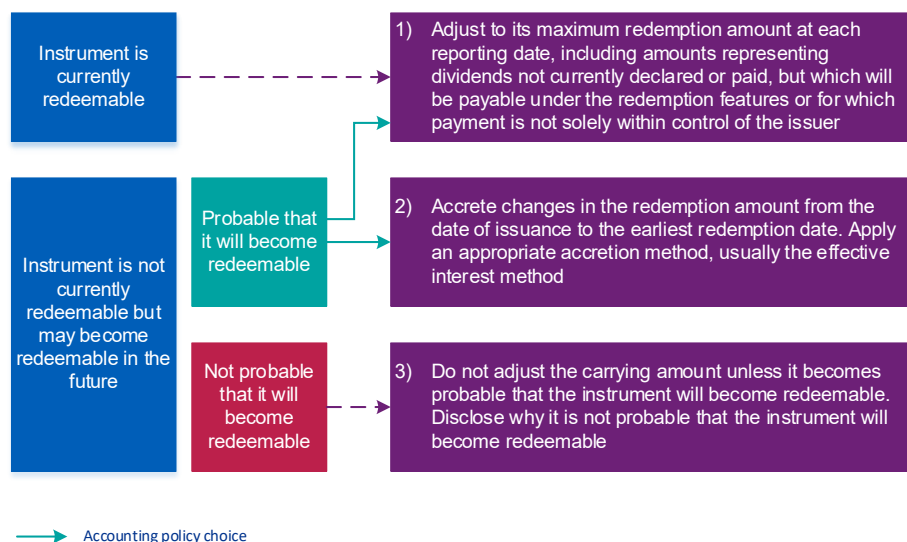
This assessment is made at each reporting date. The probability being estimated is the probability of the instrument *becoming redeemable* in the future, not the probability that it *will be redeemed*.



Question 7.4.10

What is the methodology for subsequently measuring instruments classified as temporary equity?

Interpretive response: There are three subsequent measurement models for instruments classified as temporary equity. [480-10-S99-3A(13-16)]



As the diagram indicates, Model 1 is required when an instrument is currently redeemable, and Model 3 is required when an instrument is not currently redeemable and it is not probable that it will become redeemable. However, an issuer has a choice between Models 1 and 2 when an instrument is not currently redeemable but it is probable that it will become redeemable.

The following guidance applies to these three models.

- **Instrument is measured under Model 1 and redemption amount is determined based on an index or similar variable.** Subsequent measurement is based on the conditions that exist as of the reporting date – e.g. the current fair value of the equity instrument or the most recent EBITDA measure. [480-10-S99-3A(14)]
- **Instrument measured under Model 1 or Model 2.** The following measurement guidance applies.

Initial measurement floor – the amount presented in temporary equity cannot fall below the initial amount reported in temporary equity for the instrument. Therefore, reductions in the carrying amount of a redeemable equity instrument are appropriate only to the extent that the issuer has

previously recorded increases in the carrying amount of the redeemable equity instrument.

Specific measurement exceptions apply to share-based payment awards, ESOPs and convertible debt instruments with a separated equity component (see section 7.4.50). [480-10-S99-3A(16e)]

Further, if the instrument is an NCI, the amount presented cannot fall below the current carrying amount under Subtopic 810-10. For additional guidance, see section 7.5 of KPMG Handbook, [Consolidation](#).

- **Instrument measured under Model 2.** Changes in the redemption amount are considered to be changes in accounting estimates (see Question 7.4.130). [480-10-S99-3A(15)]
- **Instrument measured under Model 3.** It is not probable that the instrument will become redeemable in the future and the rationale of why it is not probable that the instrument will become redeemable must be disclosed in the financial statements. However, if this likelihood subsequently changes and it becomes probable that it will become redeemable, the issuer switches to measuring the instrument using either Model 1 or Model 2. If Model 2 is chosen, the accretion period starts from the date the assessment of likelihood changes and runs through the earliest redemption date. [480-10-S99-3A(15)]
- **All models: temporary equity-classified instruments denominated in a foreign currency.** Additional considerations apply in accounting for the effects of foreign currency exchange rate changes on such instruments. For further guidance on foreign currency, see section 3 of KPMG Handbook, [Foreign currency](#).
- **All models: changes in carrying amount.** Resulting increases or decreases in the carrying amount of the temporary equity-classified instrument as a result of applying any of the subsequent measurement models are not recognized in net income or OCI. They are treated in the same manner as dividends on nonredeemable shares (i.e. deemed dividends) and are effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital – see chapter 5 for considerations related to the effect of dividends on components of permanent equity. [480-10-S99-3A(20)]

Such charges may also reduce or increase income available to common shareholders in calculating EPS. For further guidance on EPS, see chapter 3 of KPMG Handbook, [Earnings per share](#).



Question 7.4.20

When is a temporary equity-classified instrument considered currently redeemable?

Interpretive response: A temporary equity-classified instrument is considered 'currently redeemable' if the holder currently has the right to exercise a redemption feature and there are no conditions that need to be met (or those conditions are currently met) to effect a redemption.

Further, if a condition needs to be met for the holder to exercise a redemption feature, the instrument is still considered currently redeemable if the condition was not met as of the reporting date, but the holder controls whether the condition is met as of that date (see Question 7.4.30). [480-10-S99-3A(14) – 3A(15)]

Alternatively, a temporary equity-classified instrument is not considered 'currently redeemable' if the redemption feature cannot be exercised by the holder on the reporting date. For example, this would occur if the redemption feature can be exercised only on a future date(s) or if a redemption requires the satisfaction of conditions outside the holder's control that are not met as of the reporting date.



Question 7.4.30

What is the appropriate subsequent measurement model for an instrument that becomes redeemable when the holder, an employee, leaves the employer?

Interpretive response: We believe an employer should consider such an instrument to be currently redeemable and therefore apply Model 1 in Question 7.4.10.

Under this model, subsequent measurement is at the maximum redemption amount at the reporting date. This is because the employee can opt to leave the entity (employer) at any time. The decision to leave the employer is an action by the holder to exercise their right to redeem the instrument instead of a contingent future event for which the likelihood of occurrence is assessed.



Question 7.4.35

What is the appropriate subsequent measurement model when redemption requires a majority vote of the instrument's holders?

Interpretive response: As discussed in Question 7.3.190, temporary equity classification is appropriate when redemption is triggered by a majority vote of the instrument's holders. In this situation, the instrument is adjusted to its maximum redemption amount at each reporting date (Model 1 in Question 7.4.10). This is because the instrument holders' right to redeem upon a majority vote represents an action by the holders to exercise their right to redeem the instrument and therefore makes it currently redeemable; that right does not represent a contingency as that term is used in paragraph 480-10-S99-3A(15).



Question 7.4.40

How is 'probable' defined when assessing whether an instrument that is not currently redeemable will become redeemable in the future?

Interpretive response: The term 'probable' is used in the same manner as in Topic 450 (contingencies), which is 'the future event or events are likely to occur'. This is a higher threshold than 'more likely than not'. [450-10 Glossary]

The focus of the analysis is on whether it is probable the redemption feature will become active – not on whether the instrument will be redeemed.

- Redemption features that become active on the passage of time are considered probable for purposes of applying the subsequent measurement guidance – e.g. the instrument is redeemable after three years.
- In contrast, redemption features that are contingent on a future event require additional analysis to determine whether it is probable the instrument will become redeemable – e.g. the instrument is redeemable if the issuer raises \$1 million in additional equity in the future.

Determining whether the probable threshold is met requires an assessment of all relevant facts and circumstances and can involve significant judgment. See Questions 7.4.40, 7.4.50, and 7.4.120 to 7.4.140 for further discussion about this assessment.



Question 7.4.50

How is probability assessed when an instrument becomes redeemable on the future occurrence of a contingent event?

Interpretive response: All relevant facts and circumstances are assessed when determining whether it is probable that the contingent event will occur. Contingent events, including 'deemed liquidation events' such as those described in Example 7.3.70, can be divided into the following categories.

Events in the issuer's control

If the event that triggers redemption is in the issuer's control, the probability of the event occurring is not relevant because the redemption is considered to be solely in the issuer's control. Therefore, the instrument is classified as permanent equity and measured accordingly (see chapter 5). Exceptions may arise when the issuer is controlled by the holders of the instrument (see Question 7.4.150).

Events outside the issuer's and holder's control

In some cases, the assessment of the probability of events outside the entity and holder's control can be highly judgmental – e.g. if the redemption feature only becomes exercisable when the common shares reach a target share price. In that case, the issuer will need to assess a number of factors about the common share price, including the current price and how it compares to the

target price, historical prices, price volatility and the time to maturity of the instrument that is classified as temporary equity.

If the redemption feature only becomes exercisable on the occurrence of a change in control, or sale of all or substantially all of an issuer's assets, significant judgment may be required to assess the probability of these events. In many cases, these events may not be considered probable until the transaction is very close to being consummated because they require the agreement of a third party, and typically have significant risks to the final closing.



Example 7.4.40

Probability of the occurrence of a change in control

Issuer issues preferred shares that contain a single redemption feature – a 'deemed liquidation event' redemption clause under which the preferred shares become redeemable at their liquidation value if there is a change in control.

Issuer determines that it cannot control whether its controlling shareholder sells its stake and triggers the redemption clause and therefore classifies the preferred shares as temporary equity (see section 7.3.40). To determine the appropriate subsequent measurement model, Issuer assesses the probability of a change in control occurring.

At December 31, Issuer is aware that its controlling shareholder, which is not the holder of the preferred shares, is actively marketing its common shares; however, no purchase agreement has been announced. If the controlling shareholder sold its shares, it would trigger the change-in-control provision such that the preferred shares would become redeemable.

Issuer determines that it is not probable that the preferred shares will become redeemable because it is not probable that there will be a change in control. Even though the controlling shareholder is actively marketing its shares, there is no indication that a buyer has been found. Further, Issuer concludes that there are significant uncertainties surrounding the completion of the transaction that make it not probable of occurring, including:

- identifying a buyer in the market;
- agreeing on terms and conditions;
- obtaining regulatory approval; and
- completing all the required steps for the closing of the transaction.

Because the preferred shares are not currently redeemable and it is not probable that they will become redeemable, Issuer applies Model 3 to subsequently measure the instrument (see Question 7.4.40). Under this model, Issuer continues to present the preferred shares in temporary equity at the initial measurement amount until the change in control becomes probable. Issuer also discloses its rationale for why it believes it is not probable that the preferred shares will become redeemable.



Question 7.4.60

How are multiple mutually exclusive holder options considered in assessing whether an instrument will become redeemable?

Background: Certain preferred securities may contain multiple mutually exclusive options that are exercisable by the holder. For example, a preferred security includes the following options:

- conversion option that gives the holder the ability to convert the preferred securities to a fixed number of common shares, which is currently exercisable; and
- a holder redemption option that is not currently exercisable, but will become exercisable following the passage of a specified period of time.

These instruments are classified as temporary equity because of the existence of the holder redemption option – i.e. the holder conversion option does not ‘knock out’ the holder redemption option for the purposes of temporary equity classification.

Interpretive response: In the background example, because the holder conversion option does not knock out the holder redemption option, the issuer has to assess the probability of the instrument becoming redeemable.

The probability assessment does not factor in the likelihood of the holder converting the instrument to common shares. This is because the exercise of both the conversion option and the redemption option is controlled entirely by the holder. Absent the exercise of the conversion option by the holder, the instrument is redeemable following only the passage of time.

Therefore, it is considered probable that the instrument will become redeemable at the earliest possible redemption date regardless of the likelihood of earlier conversion, and it is remeasured using either Model 1 or Model 2 (see Question 7.4.10). [\[2005 AICPA Conf\]](#)



Question 7.4.70

When it is probable that an instrument will become redeemable in the future, is Model 1 or Model 2 preferable?

Interpretive response: As explained in Question 7.4.10, either model is acceptable; however, we generally believe issuers should apply the model that best represents the economics of the instrument. To do this, the issuer should evaluate the specific facts and circumstances of the applicable redemption feature and the level of subjectivity and assumptions necessary.

In our experience, Model 1 (the maximum redemption amount) is typically used when the redemption date is not a fixed date and/or the redemption amount is not a fixed dollar amount. Model 2 (accretion to the maximum redemption amount) is typically used in practice when the redemption date is fixed and the redemption amount is a fixed dollar amount.

If either the redemption date or amount (or both) is variable yet reasonably estimable, applying Model 2 may be more difficult. In that case, the issuer may need to make a number of assumptions and update them during the accretion period to derive an accretion pattern that represents the underlying economics.



Example 7.4.50

Determining the appropriate subsequent measurement model

Issuer issues preferred shares with the redemption clauses set out in the following scenarios. It also issues common shares that do not have any redemption rights. The common shareholders control Issuer.

Scenario 1: Preferred shareholders have option to redeem for fair value in cash at any time

The preferred shares are redeemable by the holders and are classified as temporary equity. Because they are currently redeemable, Issuer is required to measure them at the maximum redemption amount on each reporting date after issuance (Model 1), subject to the measurement floor established at their initial recognition (see section 7.4.40). To determine this maximum redemption amount, Issuer determines the fair value of the preferred shares as of the reporting date.

Scenario 2: Preferred shareholders have option to redeem for fair value in cash when three years have elapsed from issuance date

The preferred shares are redeemable by the holders and are classified as temporary equity. In this scenario, the redemption feature is not currently exercisable, but will become exercisable three years after the issuance date. Because exercisability of the redemption option depends only on the passage of time, Issuer concludes that it is probable that the preferred shares will become redeemable.

As a result, at each subsequent reporting date, Issuer has the following accounting policy choice (see Example 7.4.70).

- **Model 1.** Measure the preferred shares at the maximum redemption amount. This would be based on the fair value of the preferred shares at the reporting date.
- **Model 2.** Measure the preferred shares by accreting the difference between the maximum redemption amount (based on the fair value of the preferred shares at the reporting date) and the initial recognition amount through to the earliest redemption date (three years after the issuance date).

Scenario 3: Preferred shareholders have option to redeem for fair value in cash on occurrence of deemed liquidation events

The preferred shareholders have the option to redeem their shares for their fair value in cash on the occurrence of the following 'deemed liquidation events', none of which have occurred at the reporting date.

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- Event A: sale of significant fixed assets with a total book value of greater than \$10 million
- Event B: issuance of securities with proceeds of more than \$20 million
- Event C: merger with another entity in a board-approved transaction
- Event D: change of control through the sale of more than 50% of common shares
- Event E: delisting of the issuer's securities
- Event F: material default under an outstanding borrowing (as defined in the legal documentation for the loan).

The preferred shares are redeemable by the holders in a deemed liquidation event; however, the common shareholders do not have the same redemption rights. Therefore, the preferred shares are classified as temporary equity.

In this scenario, the redemption feature is not currently exercisable; it is contingent on the occurrence of any one of the specified deemed liquidation events. Therefore, to determine the appropriate subsequent measurement model, Issuer needs to analyze the nature of these events to determine if it can prevent them from becoming redeemable and, for those that it cannot, the probability of the events occurring. This will require assessing the facts at each reporting date and applying judgment to conclude as to the likelihood of any of them occurring.

Considerations might include the following.

- Events A to C are in Issuer's control. Therefore these events do not cause the preferred shares to be classified as temporary equity and Issuer does not need to determine the probability they will occur (see Question 7.4.50).
- Event D is outside of Issuer's control but is contingent on the current controlling shareholders successfully selling their stake (see Question 7.4.50 and Example 7.4.40).
- Event E is outside of Issuer's control. To assess whether a compulsory delisting is probable, Issuer assesses whether any other event that could result in delisting (e.g. noncompliance with listing requirements) has occurred or is probable of occurring (see Question 7.4.50).
- Event F could occur if Issuer is unable to make a payment due or otherwise does not comply with the covenants specified in the loan agreement or if Issuer intentionally withholds a payment or otherwise violates a covenant. An intentional withholding of payment or violation of covenants is in Issuer's control. However, as discussed in Example 7.3.70, whether Issuer will have sufficient liquidity to comply with all the debt covenants is outside of Issuer's control. To assess whether an unintentional default is probable, Issuer assesses its current and projected financial position and other information relevant to the covenants to conclude on the likelihood that it will default on the borrowing.

If Issuer concludes that none of the events outside its control are probable of occurring individually or in the aggregate, it continues to measure the preferred shares at their initial measurement amount at each subsequent reporting date (Model 3).

In contrast, if Issuer concludes it is probable that the redemption clause will become exercisable as a result of the occurrence of one or more of the

contingent events, then Issuer has the following subsequent measurement accounting policy choice:

- **Model 1.** Measure the preferred shares at the maximum redemption amount. This would be based on the fair value of the preferred shares at the reporting date; or
- **Model 2.** Measure the preferred shares by accreting the difference between the maximum redemption amount (based on the fair value of the preferred shares at the reporting date) and the initial recognition amount through to the earliest redemption date.

Because any of the events could occur immediately, the earliest redemption date under Model 2 is considered to be the reporting date. This means that both accounting policies will result in measuring the preferred shares at the maximum redemption amount.



Question 7.4.75

Is a redeemable instrument's subsequent measurement impacted when there are limits on the total amount of instruments that can be redeemed?

Background: Certain entities that issue redeemable shares have governing documents that limit the total amount of shares that can be redeemed. In our experience, a SPAC generally issues publicly held instruments that are redeemable by the holders at various times. However, the redemption right is subject to a limitation in the SPAC's governing documents that does not permit redemption if it would cause SPAC's net tangible assets to decline below defined thresholds.

Interpretive response: No. As discussed in Question 7.3.125, an entity must initially classify such a class of instruments in temporary equity because each share – which is the unit of account – is redeemable, despite the fact that the governing documents set an overall limit on the redemption amount. Because it is probable that the instruments will become redeemable, the entity subsequently measures them using Method 1 or Method 2 discussed in Question 7.4.10.

Regarding the background fact pattern for SPACs, the SEC staff has stated that under either method, it would object to reducing the redemption amount for any limitation based on the issuer's net tangible assets on the measurement date. This is because that approach would result in those instruments failing to be accreted to the full redemption amount under either Method 1 or Method 2. [\[2021 AICPA Conf\]](#)

**Example 7.4.55****Subsequent measurement of redeemable shares with redemption subject to a minimum net tangible assets limitation**

This Example is a continuation of Example 7.3.25. In that example, SPAC issues 1 million units – with each unit comprising one Class A common share and one warrant – in an IPO for \$10 per share (total proceeds of \$10 million). The Class A common shares are classified in temporary equity and the warrants are liability-classified.

The Class A common shares will become redeemable for \$10 each (i.e. an aggregate redemption amount of \$10 million) on or before December 31, Year 2. However, if SPAC has identified a target and a holder elects to redeem their shares immediately before consummation of a merger, SPAC is not required to redeem if redemption would result in SPAC's net tangible assets declining below \$5 million.

As discussed in Question 7.4.75, because the shares are probable of becoming redeemable for \$10 million, SPAC can subsequently measure them using Method 1 or Method 2. SPAC has an accounting policy of subsequently measuring its temporary equity-classified instruments using Method 1 – i.e. remeasuring them to their maximum redemption amount at the reporting date.

On March 31, Year 1, the warrants have an aggregate fair value of \$6 million; SPAC increases the warrant liability from \$2 million (at issuance on January 1, Year 1) to \$6 million (fair value) and records the \$4 million increase in fair value in earnings. The change in fair value of the warrants is the only transaction impacting net tangible assets before remeasuring the Class A shares.

The Class A shares are remeasured to \$10 million using Method 1 even if remeasurement of the warrants results in SPAC's net tangible assets falling below the \$5 million limitation. This occurs even though the warrants were issued in conjunction with the shares.

**Question 7.4.80****How is a subsequent remeasurement of a temporary equity-classified instrument recorded in equity?**

Interpretive response: We believe that changes to equity for deemed dividends and the remeasurement of the carrying amount of temporary equity-classified instruments are recognized based on the existing balances in retained earnings and APIC. However, an issuer should consider the requirements of applicable state laws, articles of incorporation or bylaws, and which accounts the distributions to shareholders can be made from.

Absent any specific legal requirements, we believe an issuer should record the following journal entries.

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Journal entry if issuer has retained earnings	Debit	Credit
Equity – Retained earnings	xx	
Temporary equity		xx
<i>To recognize increases in carrying amount of instrument.</i>		
Journal entry if issuer has no retained earnings	Debit	Credit
Equity – APIC	xx	
Temporary equity		xx
<i>To recognize increases in carrying amount of instrument.</i>		
Journal entry if issuer has no retained earnings and APIC is reduced to zero	Debit	Credit
Accumulated deficit	xx	
Temporary equity		xx
<i>To recognize increases in carrying amount of instrument.</i>		



Question 7.4.90

How are multiple redemption features considered in determining the applicable subsequent measurement model and amount?

Interpretive response: When determining the subsequent measurement model and amount to be recognized as temporary equity, we believe the issuer should consider only the redemption features that trigger temporary equity classification. For example, features in the issuer’s control are not considered.

Further, we believe that if there are multiple redemption features that trigger temporary equity classification (i.e. multiple redemption features that are not solely in the issuer’s control), the issuer should determine a measurement for each feature individually (under the appropriate subsequent measurement model for each feature). It should then choose the highest amount as the instrument’s measurement. These calculations should include redemption features that did not initially trigger temporary equity classification but do so at a subsequent reporting date.



Question 7.4.100

What is the appropriate measurement basis for an indexed redemption feature when redemption is contingent on the same index?

Interpretive response: An instrument may have a contingent redemption feature based on an observable index and be redeemable at a value that varies

with that index. The most common example is a redemption feature that only allows redemption when a target common share price has been met and where the redemption amount is based on the fair value of the common shares.

In this case, if the issuer concludes it is probable that the common share target price will be met, it uses the fair value of the common shares at the reporting date to measure the temporary equity-classified instrument in applying either Method 1 or Method 2.



Example 7.4.60

Subsequent measurement of an instrument with an indexed redemption feature

On January 1, Year 1, Issuer issues \$10 million of preferred shares redeemable at Holder's option if the common share price reaches \$15. If the shares become redeemable, every dollar increase in the common share price from the date of issuance increases the redemption amount of the preferred shares by \$1 million.

On issuance, the common share price is \$10, and Issuer determines it is probable the preferred shares will become redeemable because it is probable the share price will reach \$15 per share. Issuer elects to subsequently measure its temporary equity-classified preferred shares based on the maximum redemption amount (Model 1).

On December 31, Year 1, the common share price is \$12 and Issuer still believes it is probable that the shares will become redeemable. Therefore, Issuer adjusts the value of the temporary equity to \$12 million, which is the redemption amount at the reporting date.



Question 7.4.110

How are changes in estimates accounted for under Method 2?

Interpretive response: When applying Method 2 (the accretion method), an issuer estimates the timing and amount of the instrument's redemption. As with any estimate, this requires judgment and could require adjustments to the carrying amount when facts and circumstances change that affect the estimate. We believe an issuer should adopt an accounting policy to apply either the prospective or retrospective effective interest method and apply it consistently, similar to the guidance in paragraph 310-20-35-26 or paragraph 320-10-35-41.

Prospective method

The issuer adjusts the carrying amount of the instrument on a prospective basis for the changes in the expected redemption amount and/or the changes in time period from the date of change in estimates. The issuer recalculates:

- the effective interest using the carrying amount of the instrument at the date of change and the revised redemption amount and time; and

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- prospectively accretes the carrying amount of the instrument using the revised effective interest rate.

See Example 7.4.70 for an illustration of the prospective method.

Retrospective method

The issuer adjusts the carrying amount of the instrument on a retrospective basis for the changes in the expected redemption amount and/or the changes in time period from the date of change in estimates as if the revised amounts were expected from Day 1.

The issuer recalculates:

- the effective interest using the initial amount recognized for the instrument and the revised redemption amount and time; and
- accretes the carrying amount of the instrument using the revised effective interest rate.

See Example 7.4.80 for an illustration of the retrospective method.



Example 7.4.70

Applying the accretion model – prospective method for changes in estimates

On January 1, Year 1, Issuer issues preferred shares redeemable at fair value at Holder's option on any date after December 31, Year 3. No features require bifurcation and there were no other instruments issued in conjunction with the preferred shares that would require an allocation of the initial proceeds.

The following table shows the fair value of the preferred shares on the issuance date and subsequent reporting dates.

Date	Fair value
January 1, Year 1	\$50 million
December 31, Year 1	\$55 million
December 31, Year 2	\$60 million
December 31, Year 3	\$45 million
December 31, Year 4	\$52 million

Because it is probable that the preferred shares will become redeemable (i.e. they are redeemable with the passage of time), Issuer elects to measure the preferred shares using Model 2 (accretion model).

When adjusting for changes in accounting estimates, Issuer's accounting policy is to adjust prospectively from the period of the change in estimate. The journal entries at the relevant dates are as follows.

7. SEC guidance on redeemable equity-classified instruments

January 1, Year 1

	<i>Debit</i>	<i>Credit</i>
Cash	50,000,000	
Temporary equity ¹ <i>To recognize issuance of preferred shares.</i>		50,000,000
Note: 1. Initially measured at fair value (see section 7.4.20).		

December 31, Year 1

	<i>Debit</i>	<i>Credit</i>
Retained earnings ¹	1,610,000	
Temporary equity ² <i>To recognize accretion of change in redemption amount.</i>		1,610,000
Notes: 1. Issuer has a surplus of retained earnings and therefore dividends (including deemed dividends) are recorded as a reduction of retained earnings. 2. Calculated by: a. determining IRR of cash flows presuming redemption at \$55 million at earliest redemption date of January 1, Year 4 (i.e. yr 0: -50, yr 3: 55) to be 3.23% per annum; and b. multiplying initial value by this rate: \$50 million × 3.23%.		

December 31, Year 2

	<i>Debit</i>	<i>Credit</i>
Retained earnings	4,040,000	
Temporary equity ¹ <i>To recognize accretion of change in redemption amount.</i>		4,040,000
Note: 1. Calculated by: a. determining IRR of cash flows presuming redemption at \$60 million at earliest redemption date of January 1, Year 4 (i.e. yr 1: -51.61, yr 3: 60) to be 7.82% per annum b. applying this rate to revised value at December 31, Year 1 for two years: \$51.61 million × 7.82% = \$4.04 million.		

7. SEC guidance on redeemable equity-classified instruments

December 31, Year 3

	<i>Debit</i>	<i>Credit</i>
Temporary equity ¹	5,650,000	
Retained earnings		5,650,000
<i>To recognize reversal of amount accreted.</i>		
Note:		
1. \$5.65 million as noted in Year 2 of total accretion amount at December 31, Year 2 (assuming accretion of Year 3 is recorded annually and ignored for simplicity purposes). This reverses the increases to temporary equity recognized in Years 1 and 2. The redemption amount on this date is less than the initial recognition amount. However, amounts previously accreted are reversed only to the extent they were previously recognized, whereby the subsequent measurement of the preferred shares will never be lower than their initial recognition amount.		

December 31, Year 4

	<i>Debit</i>	<i>Credit</i>
Retained earnings	2,000,000	
Temporary equity ¹		2,000,000
<i>To recognize accretion to current redemption amount.</i>		
Note:		
1. Current redemption amount less previous carrying amount: \$52 million – \$50 million. At all reporting dates following January 1, Year 4, Holders can redeem the preferred shares at any time; therefore, the preferred shares are currently redeemable and are measured at the maximum redemption amount.		

**Example 7.4.80****Applying the accretion model – retrospective method for changes in estimates**

On January 1, Year 1, Issuer issues preferred shares redeemable at fair value at the option of the holder on any date after December 31, Year 3. No features require bifurcation and there were no other instruments issued in conjunction with the preferred shares that would require an allocation of the initial proceeds.

The following table shows the fair value of the preferred shares on the issuance date and subsequent reporting dates.

Date	Fair value
January 1, Year 1	\$50 million
December 31, Year 1	\$55 million
December 31, Year 2	\$60 million

7. SEC guidance on redeemable equity-classified instruments

Date	Fair value
December 31, Year 3	\$45 million
December 31, Year 4	\$52 million

Because it is probable that the preferred shares will become redeemable (i.e. they are redeemable as a result of the passage of time), Issuer has elected to measure the preferred shares using Model 2 (accretion model).

When adjusting for changes in accounting estimates, Issuer's accounting policy is to adjust retrospectively in the period of the change in estimate. The journal entries at the relevant dates are as follows.

January 1, Year 1

	<i>Debit</i>	<i>Credit</i>
Cash	50,000,000	
Temporary equity ¹ <i>To recognize issuance.</i>		50,000,000
Note:		
1. Initially measured at fair value (see section 7.4.20).		

December 31, Year 1

	<i>Debit</i>	<i>Credit</i>
Retained earnings ¹	1,610,000	
Temporary equity ² <i>To recognize accretion of change in redemption amount.</i>		1,610,000
Notes:		
1. Issuer has a surplus of retained earnings and therefore dividends (including deemed dividends) are recorded as a reduction of retained earnings.		
2. Calculated by:		
a. determining IRR of cash flows presuming redemption at \$55 million at earliest redemption date of January 1, Year 4 (i.e. yr 0: -50, yr 3: 55) to be 3.23% per annum; and		
b. multiplying initial value by this rate: \$50 million × 3.23%.		

December 31, Year 2

	<i>Debit</i>	<i>Credit</i>
Retained earnings	4,850,000	
Temporary equity ¹ <i>To recognize accretion of change in redemption amount.</i>		4,850,000

7. SEC guidance on redeemable equity-classified instruments

Note:

1. Calculated by:
 - a. determining IRR of cash flows presuming redemption at \$60 million at earliest redemption date of January 1, Year 4 (i.e. yr 0: -50, yr 3: 60) to be 6.27% per annum;
 - b. applying this rate to initial value for two years: (\$50 million \times 6.27% = \$3.13 million) + (\$53.13 million \times 6.27%) = \$3.33 million for a total of \$6.46 million for two years; and
 - c. subtracting deemed dividend recognized in Year 1: \$6.46 million – \$1.61 million = \$4.85 million.

December 31, Year 3

	<i>Debit</i>	<i>Credit</i>
Temporary equity ¹	6,460,000	
Retained earnings		6,460,000
<i>To recognize reversal of amount accreted.</i>		

Note:

1. \$4.85 million + \$1.61 million = \$6.46 million. Reverses the increases to temporary equity recognized in Years 1 and 2. The redemption amount on this date is less than the initial recognition amount. However, amounts previously accreted are reversed only to the extent that they were previously recognized such that the subsequent measurement of the preferred shares will never be lower than its initial recognition amount.

December 31, Year 4

	<i>Debit</i>	<i>Credit</i>
Retained earnings	2,000,000	
Temporary equity ¹		2,000,000
<i>To recognize accretion to current redemption amount.</i>		

Note:

1. Current redemption amount less previous carrying amount: \$52 million – \$50 million. At all reporting dates following January 1, Year 4, Holders can redeem the preferred shares at any time; therefore, the preferred shares are currently redeemable and are measured at the maximum redemption amount.



Example 7.4.90

Applying the accretion model – fixed dollar redemption amount

On January 1, Year 1, Issuer issues \$50 million of preferred shares, which are redeemable for \$55 million at the option of Holder on any date after December 31, Year 3. No features required bifurcation and there were no other

7. SEC guidance on redeemable equity-classified instruments

instruments issued in conjunction with the preferred shares that would require an allocation of the initial proceeds.

Because it is probable that the preferred shares will become redeemable (i.e. they are redeemable with the passage of time), Issuer elects to measure the preferred shares using the accretion model (Model 2).

The journal entries at the relevant dates are:

January 1, Year 1

	<i>Debit</i>	<i>Credit</i>
Cash	50,000,000	
Temporary equity ¹		50,000,000
<i>To recognize issuance of preferred shares.</i>		
Note:		
1. The preferred shares are initially measured at fair value (see section 7.4.20).		

December 31, Year 1

	<i>Debit</i>	<i>Credit</i>
Retained earnings ¹	1,610,000	
Temporary equity ²		1,610,000
<i>To recognize accretion of change in redemption amount.</i>		
Notes:		
1. Issuer has a surplus of retained earnings and therefore dividends (including deemed dividends) are recorded as a reduction of retained earnings.		
2. Calculated by:		
a. determining IRR of cash flows presuming redemption at \$55 million at earliest redemption date of January 1, Year 4 (i.e. yr 0: -50, yr 3: 55) to be 3.23% per annum; and		
b. multiplying initial value by this rate: \$50 million × 3.23%.		

December 31, Year 2

	<i>Debit</i>	<i>Credit</i>
Retained earnings	1,670,000	
Temporary equity ¹		1,670,000
<i>To recognize accretion of change in redemption amount.</i>		
Note:		
1. IRR applied to revised carrying amount at December 31, Year 1: \$51.61 million × 3.23%.		

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December 31, Year 3

	<i>Debit</i>	<i>Credit</i>
Retained earnings	1,720,000	
Temporary equity ¹		1,720,000
<i>To recognize accretion of change in redemption amount.</i>		
Note:		
1. IRR applied to revised carrying amount at December 31, Year 2: \$53.28 million × 3.23%.		

**Example 7.4.110****Applying the maximum redemption amount model**

On January 1, Year 1, Issuer issues preferred shares redeemable at fair value at Holder's option on any date after December 31, Year 3. No features require bifurcation and there were no other instruments issued in conjunction with the preferred shares that would require an allocation of the initial proceeds.

The following table shows the fair value of the preferred shares on the issuance date and subsequent reporting dates.

Date	Fair value
January 1, Year 1	\$50 million
December 31, Year 1	\$55 million
December 31, Year 2	\$60 million
December 31, Year 3	\$45 million
December 31, Year 4	\$52 million

Because it is probable that the preferred shares will become redeemable (i.e. they are redeemable based on the passage of time), Issuer has elected to measure the preferred shares at their maximum redemption amount (Model 1).

The journal entries at the relevant dates are as follows.

January 1, Year 1

	<i>Debit</i>	<i>Credit</i>
Cash	50,000,000	
Temporary equity ¹		50,000,000
<i>To recognize issuance of preferred shares.</i>		
Note:		
1. The preferred shares are initially measured at fair value (see section 7.4.20).		

7. SEC guidance on redeemable equity-classified instruments

December 31, Year 1

	<i>Debit</i>	<i>Credit</i>
Retained earnings ¹	5,000,000	
Temporary equity		5,000,000
<i>To recognize change in redemption amount.</i>		
Note:		
1. Issuer has a surplus of retained earnings and therefore dividends (including deemed dividends) are recorded as a reduction of retained earnings: maximum redemption amount of \$55 million less carrying amount of \$50 million.		

December 31, Year 2

	<i>Debit</i>	<i>Credit</i>
Retained earnings ¹	5,000,000	
Temporary equity		5,000,000
<i>To recognize change in redemption amount.</i>		
Note:		
1. Maximum redemption amount less carrying amount: \$60 million – \$55 million.		

December 31, Year 3

	<i>Debit</i>	<i>Credit</i>
Temporary equity ¹	10,000,000	
Retained earnings		10,000,000
<i>To recognize reversal of change in redemption amount.</i>		
Note:		
1. Reverses the increases to temporary equity recognized in Years 1 and 2. The fair value on this date is less than the initial recognition amount. However, any reductions to the carrying amount are restricted to the extent that Issuer previously recognized increases in the carrying amount such that the subsequent measurement of the preferred shares will never be lower than its initial recognition amount.		

December 31, Year 4

	<i>Debit</i>	<i>Credit</i>
Retained earnings	2,000,000	
Temporary equity ¹		2,000,000
<i>To recognize current redemption amount.</i>		
Note:		
1. Maximum redemption amount less carrying amount: \$52 million – \$50 million.		

**Example 7.4.120****Applying the maximum redemption amount model – fixed dollar redemption amount**

On January 1, Year 1, Issuer issues \$50 million of preferred shares, which are redeemable for \$55 million at Holder's option on any date after December 31, Year 3. No features require bifurcation and there were no other instruments issued in conjunction with the preferred shares that would require an allocation of the initial proceeds.

Because it is probable that the preferred shares will become redeemable (i.e. they are redeemable based on the passage of time), Issuer has elected to measure the preferred shares at their maximum redemption amount (Model 1).

The journal entries at the relevant dates are as follows.

January 1, Year 1

	<i>Debit</i>	<i>Credit</i>
Cash	50,000,000	
Temporary equity ¹		50,000,000
<i>To recognize issuance.</i>		
Note:		
1. The preferred shares are initially measured at fair value (see section 7.4.20).		

December 31, Year 1

	<i>Debit</i>	<i>Credit</i>
Retained earnings ¹	5,000,000	
Temporary equity		5,000,000
<i>To recognize preferred shares at their redemption amount on Issuer's next reporting date.</i>		
Note:		
1. Issuer has a surplus of retained earnings and therefore dividends (including deemed dividends) are recorded as a reduction of retained earnings: maximum redemption amount of \$55 million less initial carrying amount of \$50 million.		

**Question 7.4.120****How is a change from 'probable' to 'not probable' in the likelihood of an instrument becoming redeemable treated?**

Interpretive response: At each reporting date, an issuer of a not-currently redeemable temporary equity-classified instrument assesses whether it is probable that this instrument will become redeemable in the future. This

assessment can change from one reporting date to another as the facts and circumstances change.

When the assessment changes from 'probable' to 'not probable', we believe the issuer maintains the current carrying amount of the instrument with no further adjustments made (assuming no further changes in the probability assessment).

Further, the issuer discloses the rationale as to why it is no longer probable that the instrument will become redeemable (see section 7.5.10).



Question 7.4.130

How is the expected earliest redemption date determined under Method 2?

Interpretive response: Under the accretion method (Method 2), the difference between the initial measurement amount and the maximum redemption amount is accreted over the period from initial recognition to the earliest redemption date. The earliest redemption date is the date on which a not-currently redeemable instrument will become redeemable. In some cases, this date is contractually specified – e.g. when the redemption option can be exercised at any point in time after two years have elapsed since issuance. In other cases, such as when the redemption feature becomes currently exercisable only on the occurrence of a contingent event, the earliest redemption date is not known and will need to be estimated.

In practice, the contingent events that trigger redemption are often material transactions, including those described as 'deemed liquidation events'. As discussed in Question 7.4.50, given the significant uncertainties around the completion of these transactions, we believe that the time between when it becomes probable that an instrument will be redeemable and then becoming currently redeemable will be short in most situations, such that the effect of changing this estimate is likely to be limited. However, if such a period spans two or more reporting dates and the issuer's estimation of the earliest redemption date changes, an adjustment to the accretion method needs to be made. Example 7.4.70 illustrates how to apply the accretion method.



Question 7.4.140

How are settlement clauses other than redemption clauses considered when determining if it is probable a not-currently redeemable instrument will become redeemable in the future?

Interpretive response: In some cases, the temporary equity-classified instrument has other features that could result in its settlement before the redemption feature becomes exercisable (e.g. a conversion feature). These are often referred to as knock-out clauses; see Questions 7.2.150 and 7.3.170 for

consideration of these clauses in the scoping and classification analysis. These features may be:

- at the option of the holder of the instrument;
- at the option of the issuer of the instrument; or
- triggered by uncertain future events.

The assessment is based on numerous factors, such as:

- Who controls whether the knock-out clause would be exercised?
- Does exercising the knock-out clause make economic sense for the issuer or holder?

Scenario 1: At the option of the holder of the instrument

Example instrument: preferred shares with a currently exercisable holder's conversion option (knock-out clause) and a holder's redemption option that becomes exercisable after three years.

In this scenario, the knock-out clause and redemption feature are both in the holder's control. As discussed in Question 7.4.50, the conversion option is ignored and it is considered probable that the preferred shares will become redeemable because the redemption option requires only the passage of time to become exercisable. This conclusion does not change even if the conversion option is economically more beneficial to the holder.

Scenario 2: At the option of the issuer of the instrument

Example instrument: preferred shares that are redeemable by the holder for par after three years solely due to the passage of time or convertible by the issuer at any time.

When determining if this instrument would be converted or redeemed at a time different from the probable holder redemption date of three years from date of issuance, the issuer has to consider all facts and circumstances. This includes whether it has the ability to convert, including if there are enough shares available for conversion under Section 815-40-25; see section 8.12.20.

Scenario 3: Triggered by uncertain future events

Example instrument: preferred shares redeemable in five years at the option of the holder if a qualified IPO does not occur in that period. On a qualified IPO, the preferred shares mandatorily convert to nonredeemable common shares (i.e. the redemption option is knocked out). A qualified IPO is defined by various characteristics, including selling a sufficient number of shares in a registered offering at a certain minimum price.

We believe it is appropriate for an issuer's accounting policy to incorporate the likelihood of a knock-out clause in evaluating whether it is probable that a redemption feature will become redeemable. However, we believe such a policy requires significant evidence to support management's judgment that it is not probable that the instrument will become redeemable. For this example instrument, management would need to conclude that it is not probable that the qualified IPO will occur (see Question 7.4.50).

We understand that some entities do not incorporate the likelihood of events such as IPOs and business combinations occurring when evaluating whether it is probable that a security will become redeemable. This may be analogous to

7. SEC guidance on redeemable equity-classified instruments

paragraphs 805-20-55-50 and 55-51 dealing with contractual termination benefits and curtailment losses that will occur only if the business combination is consummated, in which case a liability is not recognized until the business combination occurs.

Therefore, we believe it is acceptable to adopt an accounting policy that the events triggering the knock-out clause are too difficult to predict, and that subsequent remeasurement of the temporary equity-classified instrument should continue until the events actually occur. The policy chosen should be applied consistently for all similar instruments.

The example instrument in this scenario is different from the fact pattern discussed in a 2005 SEC staff speech in that the holder of the preferred shares cannot choose between settling in cash or common shares, either directly or indirectly. For the instrument in this example, the holder is contractually required to accept nonredeemable common shares should the contingent event (IPO) occur and will lose its contractual right to redeem in those circumstances. Further, the holder does not have control over whether the contingent knock-out event (i.e. the qualified IPO) transpires.

In contrast, in the fact pattern discussed by the SEC staff, subsequent remeasurement is required because the ultimate choice of cash or share settlement lies with the holder of the instrument. While presentation as temporary equity is required in the fact pattern discussed by the SEC because conversion is outside the unilateral control of the issuer, the temporary equity guidance does not suggest that a contingent knock-out clause outside the control of the holder is evaluated differently from other contingencies when evaluating whether it is probable an instrument that is not currently redeemable will become redeemable. [\[2005 AICPA Conf\]](#)

For issuers that adopt a policy of considering IPOs and other similar contingent knock-out clauses, we believe all facts and circumstances should be considered in evaluating whether the contingent knock-out feature indicates that it is not probable an instrument will become redeemable. Because IPOs and business combinations are typically difficult to predict, issuers need to present compelling evidence if a contingent feature based on such events is considered likely enough to make it not probable that a redemption feature based solely on the passage of time would become redeemable. That evidential matter could include both quantitative and qualitative evidence, such as Monte Carlo simulations using appropriate inputs and market-based evidence – e.g. filing a Form S-1 based on indications from investment bankers that a qualified offering is feasible in the near term.

In general, the longer the term and more speculative the nature of the evidence, the more difficult it is to support a conclusion that subsequent remeasurement is not required. Further, the probability assessment is reassessed each period. If it becomes probable that the instrument will become redeemable, the issuer begins subsequently remeasuring the instrument from that point forward using either Model 1 or Model 2.

Further, such a policy applies only to contingent events that are outside the holder's control. If the holder can block the contingent event that would prevent the instrument from becoming redeemable, the ultimate resolution as to whether it is probable the instrument becomes redeemable lies with the holder, and the instrument's carrying amount must be remeasured (see Scenario 1).

Therefore, in this scenario, the issuer determines the likelihood that the contingent event will occur and, if this was not probable, the issuer would conclude that it is probable that the instrument will become redeemable.



Question 7.4.150#

How is the subsequent measurement of an instrument affected when the holder controls the issuer's board?

Interpretive response: As discussed in Question 7.3.140, if redemption of the equity-classified instrument is within the issuer's control but the holders control the issuer, the issuer classifies the instrument as temporary equity.

The appropriate subsequent measurement of such an instrument depends on the feature resulting in temporary equity classification.

- **Issuer redemption option:** If the issuer can currently exercise its option to redeem the instrument, the instrument is adjusted to its maximum redemption amount at each reporting date (Model 1 in Question 7.4.10). This is not a contingency as that term is used in paragraph 480-10-S99-3A(15), but instead an action by the holder to exercise its right to redeem the instrument.
- **Contingent event that would otherwise be considered to be within the issuer's control (e.g. the sale of a given value of assets):** If the instrument is not currently redeemable, but is contingent on a future event, the issuer determines whether it is probable the instrument will become redeemable (see section 7.3.30). This probability assessment considers all factors, including events in the control of the issuer. Once the issuer completes this assessment, it can then determine which of the three subsequent measurement models in Question 7.4.10 to apply.



Question 7.4.160

How is the maximum redemption amount determined if the redemption amount is based on a measure at a measurement date other than the reporting date?

Background: Assume an instrument is redeemable due to a redemption feature that becomes exercisable at a future date and the amount paid at redemption is based on a measure taken over a specified period of time – e.g. sales or EBITDA of the fiscal year preceding redemption.

In this case, the issuer needs to determine what value should be ascribed to the maximum redemption amount. Paragraph 480-10-S99-3A(14) requires that the amount presented in temporary equity be calculated based on the conditions that exist as of the reporting date – e.g. the current fair value of the equity instrument or the most recent EBITDA measure. The issuer does not attempt to forecast amounts when calculating the redemption amount.

Interpretive response: In the background example, an issue arises in applying the guidance in paragraph 480-10-S99-3A(14) when the stated period for calculating the metric on which the redemption amount is based does not end on a date that coincides with the reporting date.

For example, this occurs when the redemption amount is calculated based on sales over a 12-month period to October 31 prior to the redemption date in the future and the reporting date is December 31 of the current year. In those circumstances, we believe that the issuer has an accounting policy choice to use historical sales from either:

- the 12-month period ending October 31 in the current year; or
- the most recent 12-month period ending December 31.



Example 7.4.130

Determining the maximum redemption amount when it is contingent on a variable metric

On January 1, Year 1, Issuer issues preferred shares that become redeemable in five years and have a redemption amount that is based on sales for the trailing 12-month period ending September 30, Year 5 as follows:

- if sales are less than \$100 million, redemption is at 100% of the par value;
- if sales are between \$100 million and \$150 million, redemption is at 110% of the par value; and
- if sales are above \$150 million, redemption is at 120% of the par value.

When preparing its financial statements at December 31, Year 1, we believe Issuer may make an accounting policy choice to use the actual sales:

- for the 12 months to September 30, Year 1 (the directly comparable period to that in the redemption clause); or
- those for the 12 months to December 31, Year 1 (the most recent 12 months of sales data).



Question 7.4.170

Can an entity apply the fair value option to a temporary equity-classified instrument?

Interpretive response: No. Paragraph 825-10-15-5-f(f) specifically states that the fair value option cannot be applied to equity-classified (including temporary equity-classified) instruments. Therefore, an issuer of temporary equity-classified instruments needs to follow the measurement provisions in the temporary equity guidance. [480-10-S99-3A(17), 825-10-15-5(f)]



Question 7.4.180

How is the subsequent measurement of a currently redeemable host contract affected when its embedded derivative is separated?

Background: Under Topic 815, an embedded derivative that has been separated from an equity-classified hybrid instrument is recorded at fair value. The difference between the issuance proceeds of the hybrid instrument and the derivative's fair value is recorded as the initial carrying amount of the host contract that is classified in equity. [815-15-30-2]

Interpretive response: Although the derivative is presented separately from the equity host instrument as an asset or liability, if the host instrument is classified as temporary equity, we believe the total amount recognized for the hybrid instrument should sum to the instrument's maximum redemption amount. Therefore, the amount recognized as temporary equity is the maximum redemption amount plus or minus the value of any associated derivative liability or asset, respectively.

As discussed in Question 7.2.160, if the redemption feature is the embedded feature that has been separated from the equity host, we believe the host contract should be classified as temporary equity.

7.4.50 Subsequent measurement exceptions



Excerpt from ASC 480-10

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings
- • > SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

Measurement

1. The following additional guidance is relevant to the application of the SEC staff's views in paragraphs 14 and 15:
 - a. For share-based payment arrangements with employees, the amount presented in temporary equity at each balance sheet date should be based on the redemption provisions of the instrument and should take into account the proportion of consideration received in the form of employee services (that is, the pattern of recognition of compensation cost pursuant to Topic 718). ^{FN14}
 - FN14 See also the Interpretative Response to Question 2 in Section E of Section 718-10-S99.
 - b. For employee stock ownership plans where the cash redemption obligation relates only to a market value guarantee feature, the

7. SEC guidance on redeemable equity-classified instruments

registrant may elect as an accounting policy to present in temporary equity either (i) the entire guaranteed market value amount of the equity securities or (ii) the maximum cash obligation based on the fair value of the underlying equity securities at the balance sheet date...

- d. For convertible debt instruments that contain a separately classified equity component, an amount should be presented in temporary equity only if the instrument is currently redeemable or convertible at the balance sheet date for cash or other assets (see paragraph 3(e)). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion at the balance sheet date over (2) the carrying amount of the liability-classified component of the convertible debt instrument at the balance sheet date. ^{FN15}

FN15 ASR 268 does not impact the application of other applicable GAAP to the accounting for the liability component or the accounting upon derecognition of the liability and/or equity component.

- e. For a redeemable equity instrument other than those discussed in (a), (b), and (d) of this paragraph, regardless of the accounting method applied in paragraphs 14 and 15, the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument from the application of paragraphs 14 and 16 are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument from the application of paragraphs 14 and 15.

The exceptions to the general subsequent measurement guidance are for the following specific instruments.

Instrument	Subsequent measurement
Equity-classified components of convertible debt instruments – e.g. substantial premium ¹ [480-10-S99-3A(16d)]	The same model applied at initial measurement is used for subsequent measurement – i.e. the portion of the equity-classified component recognized in temporary equity is the excess of the redemption amount over the carrying amount of the liability component of the convertible instrument. Any portion of the equity-classified component in permanent equity is not remeasured unless it is determined to be temporary equity.
Note: 1. This exception also applies to convertible preferred shares that are classified as a liability under Topic 480 (see chapter 6).	
Share-based payment awards [480-10-S99-3A(16a)]	Measurement of the amount to be recognized in temporary equity for a share-based payment arrangement subsequent to initial recognition is the same as that applicable on initial measurement – i.e. a proportionate amount of the redemption amount.

7. SEC guidance on redeemable equity-classified instruments

Instrument	Subsequent measurement
	<p>For example, an arrangement for shares cliff vests after four years and the redemption feature gives participants the option to sell back to the issuer at fair value six months after vesting. At the end of Year 2, the issuer would recognize 50% (the 'proportionate amount') of the fair value (the 'redemption amount') of the underlying securities in temporary equity.</p> <p>Applying this guidance will generally result in recognizing in temporary equity an amount different from the expense recognized under Topic 718. This is because the Topic 718 periodic expense is based on the fair value of the awards on the grant date, whereas the temporary equity measurement is based on the proportionate amount of the redemption amount at each reporting date. The difference is recorded to APIC. See KPMG Handbook, Share-based payment, for further guidance.</p>
ESOPs [480-10-S99-3A(16b)]	<p>The same model applied at initial measurement is used for subsequent measurement – i.e. when the cash redemption obligation relates only to a market value guarantee feature, the issuer follows its accounting policy choice to recognize in temporary equity either:</p> <ul style="list-style-type: none"> — the entire guaranteed market value of the securities; or — the maximum cash obligation based on the fair value of the security at the reporting date.
NCI	See section 7.5 of KPMG Handbook, Consolidation .

7.4.60 Reclassification between temporary equity and permanent equity



Excerpt from ASC 480-10

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings
- > SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

Reclassifications into Permanent Equity

1. If classification of an equity instrument as temporary equity is no longer required (if, for example, a redemption feature lapses, or there is a modification of the terms of the instrument), the existing carrying amount of the equity instrument should be reclassified to permanent equity at the date of the event that caused the reclassification. Prior financial statements are not adjusted. Additionally, the SEC staff believes that it would be

7. SEC guidance on redeemable equity-classified instruments

inappropriate to reverse any adjustments previously recorded to the carrying amount of the equity instrument (pursuant to paragraphs 14–16) in conjunction with such reclassifications.

If, after initial recognition, a temporary equity-classified instrument no longer meets the classification criteria for temporary equity, the carrying amount is remeasured up to the date of the reclassification and then reclassified to permanent equity at that date. Additional adjustments are not made to the carrying amount in subsequent periods and prior-period financial statements are not adjusted. [480-10-S99-3A(18)]

If, subsequent to initial recognition, a permanent equity-classified instrument meets the classification criteria for temporary equity, it is reclassified to temporary equity at that date.



Question 7.4.190

When preferred stock is reclassified from permanent equity to temporary equity, how is it measured at the date of reclassification?

Interpretive response: The temporary equity guidance does not address how to account for the reclassification. We believe either of the following measurements is acceptable as an accounting policy election consistently applied.

- **Current carrying amount:** The preferred stock is reclassified from permanent equity to temporary equity at its current carrying amount (including any issuance costs). After reclassification, the subsequent measurement guidance in this section 7.4 is then applied. If the instrument is currently redeemable for an amount greater than its carrying amount, the carrying amount is immediately adjusted to the redemption amount with the resulting increase or decrease treated in the same manner as dividends on nonredeemable shares (see Question 7.4.10).
- **Current fair value:** The preferred stock is reclassified from permanent equity to temporary equity at its fair value at the date of the reclassification. This approach is based on the general guidance in paragraph 480-10-S99-3A, subparagraph 12 which states, “The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its *issuance date fair value*” meaning that the entity should transfer the instrument at its current fair value on the date of reclassification (unless an exception applies – see initial measurement exceptions in section 7.4.30). The difference between the previous carrying amount and fair value (unless the initial measurement exception applies) is recognized as an adjustment to equity (APIC) on the date of reclassification. This accounting treatment is analogous to the reclassification guidance in Subtopic 815-40.

When preferred stock is modified in a restructuring and the modification is accounted for as an extinguishment of the old instrument and recognition of a new instrument, the new preferred stock is recognized at its fair value (see

Question 5.4.80 for further guidance), regardless of whether the new preferred stock is permanent equity or temporary equity classified.



Example 7.4.140

Reclassification of preferred shares from temporary equity to permanent equity

Continuing Example 7.4.60, Issuer has been measuring its preferred shares that are temporary equity-classified based on the maximum redemption amount.

The preferred shares were previously determined to be temporary equity-classified because they are redeemable at the option of Holder if the common share price reaches a price target of \$15 (issued at \$10 per share). If the shares become redeemable, every dollar increase in the common share price from the date of issuance increases the redemption amount of the preferred shares by \$1 million.

The redemption feature is for five years, and after the fifth year, if the common share price does not reach \$15, the preferred shares are no longer redeemable.

Through the first four years, Issuer determines it is probable the preferred shares will become redeemable because the share price will reach \$15 per share. As of December 31, Year 4, the common share price is \$14 per share. Therefore, Issuer adjusts the carrying amount of temporary equity to \$14 million, which is the redemption amount at the reporting date.

On December 31, Year 5, the share price is \$14 and because the common share price did not reach the \$15 threshold, the holder redemption option expires unexercised. Therefore, the preferred shares are no longer redeemable and do not meet the requirements for temporary equity classification. Therefore, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Temporary equity	14,000,000	
Preferred shares		14,000,000
<i>To reclassify temporary equity to permanent equity because preferred shares can no longer be redeemed.</i>		



Example 7.4.150

Reclassification of convertible preferred shares from permanent equity to temporary equity

Issuance of shares

On January 1, Year 1, ABC Registrant issues convertible preferred shares for their aggregate par amount of \$10 million.

7. SEC guidance on redeemable equity-classified instruments

The holder has the option to convert each convertible preferred share at any time to 20 of ABC's \$1 par value common shares (i.e. a conversion price of \$50 per share). The fair value of ABC common shares at the issuance date is \$40 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 if-converted value); an instrument with this feature is commonly referred to as 'Instrument X'.

The shares do not contain embedded features other than the conversion option.

The shares are initially classified in permanent equity. The convertible preferred shares are in the scope of the 'no proceeds allocated' model. Therefore, none of the other convertible debt models are relevant as follows.

- The conversion option is not separately accounted for as a derivative.
- Because the shares were issued for their par value, they were not issued at a substantial premium.

For simplicity, this example does not reflect issuance costs.

Modification of issued shares and reclassification

On January 1, Year 10, the contractual terms of the convertible preferred shares are modified to require ABC to settle the par amount in cash upon conversion – i.e. it is contractually modified to be what is commonly referred to as 'Instrument C'. On that date, shares have a carrying amount of \$10 million and an if-converted value of \$50 million.

ABC concludes that the modification does not represent an induced conversion and should be accounted for as a modification (i.e. a continuation of the existing shares, not an extinguishment of the existing shares with issuance of new shares).

After the modification, the shares are classified in temporary equity because they are convertible at the holder's option and ABC is required to settle the par amount of converted shares with cash. How the reclassification of the convertible preferred shares is measured in ABC's financial statements depends on the accounting policy that ABC elects for the measurement.

Section 6.13 in KPMG Handbook, [Earnings per share](#), discusses the EPS calculations.

Scenario 1: Current carrying amount

ABC reclassifies the convertible preferred shares at their current carrying amount of \$10 million. ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Preferred shares	10,000,000	
Temporary equity		10,000,000
<i>To reclassify convertible preferred shares from permanent equity to temporary equity because the issuer is required to settle the par amount in cash upon conversion.</i>		

Scenario 2: Current fair value

ABC reclassifies the convertible preferred shares at their current fair value of \$50 million. ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Preferred shares	10,000,000	
APIC	40,000,000	
Temporary equity		50,000,000
<i>To reclassify convertible preferred shares from permanent equity to temporary equity because the issuer is required to settle the par amount in cash upon conversion.</i>		

7.4.70 Redemptions, conversion and induced conversions of preferred stock

Question 5.4.35 addresses the accounting for settlements of preferred stock, including temporary equity-classified preferred stock. The accounting depends on the type of settlement – i.e. repurchase or redemption, conversion (other than induced conversion) or induced conversion. Section 7.4.60 discusses reclassifications between temporary equity and permanent equity.

7.5 Disclosure

7.5.10 Overview



Excerpt from CFRR 211

Redeemable Preferred Stocks

4. Footnote Disclosure of Future Cash Obligations

ASR 268:

In the interest of clear and prominent disclosure of the future cash obligations attendant with these types of securities, the rules require disclosure of the term of redemption, five-year maturity data, and changes in these securities in a separate note to the financial statements captioned "Redeemable Preferred Stocks." It should be noted that although in the past a registrant may have disclosed changes in redeemable preferred stocks in a statement of stockholders' equity, such changes are now required to be disclosed in a separate note as described above.



Excerpt from ASC 480-10

> SEC Staff Guidance

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings
- • > SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A

Disclosures

24. ASR 268 and SEC Regulation S-X require certain disclosures about redeemable equity instruments. In addition, the SEC staff expects the following disclosures to be provided in the notes to the financial statements:
- a. A description of the accounting method used to adjust the redemption amount of a redeemable equity instrument (as discussed in paragraphs 14–16).
 - b. When a registrant elects to accrete changes in the redemption amount of a redeemable equity instrument in accordance with paragraph 15(a), the redemption amount of the equity instrument as if it were currently redeemable.
 - c. For a redeemable equity instrument that is not adjusted to its redemption amount, the reasons why it is not probable that the instrument will become redeemable.
 - d. When charges or credits discussed in paragraphs 20 and 22(a) are material, a reconciliation between net income and income available to common stockholders.
 - e. The amount credited to equity of the parent upon the deconsolidation of a subsidiary (as discussed in paragraph 19).



Excerpt from Regulation S-X Rule 5-02

Balance Sheet

The following is the text of Regulation S-X Rule 5-02, Balance Sheets (17 CFR 210.5-02).

The purpose of this rule is to indicate the various line items and certain additional disclosures which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the balance sheets or related notes filed for the persons to whom this article pertains (see § 210.4–01(a)).

Redeemable Preferred Stocks.

27. Preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer.

7. SEC guidance on redeemable equity-classified instruments

- a. Include under this caption amounts applicable to any class of stock which has any of the following characteristics:
- (1) it is redeemable at a fixed or determinable price on a fixed or determinable date or dates, whether by operation of a sinking fund or otherwise;
 - (2) it is redeemable at the option of the holder; or
 - (3) it has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings.

Amounts attributable to preferred stock which is not redeemable or is redeemable solely at the option of the issuer shall be included under § 210.5-02.28 unless it meets one or more of the above criteria.

- b. State on the face of the balance sheet the title of each issue, the carrying amount, and redemption amount. (If there is more than one issue, these amounts may be aggregated on the face of the balance sheet and details concerning each issue may be presented in the note required by paragraph (c) below.) Show also the dollar amount of any shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom.

If the carrying value is different from the redemption amount, describe the accounting treatment for such difference in the note required by paragraph (c) below.

Also state in this note or on the face of the balance sheet, for each issue, the number of shares authorized and the number of shares issued or outstanding, as appropriate (See § 210.4-07).

- c. State in a separate note captioned "Redeemable Preferred Stocks"
- (1) a general description of each issue, including its redemption features (e. g. sinking fund, at option of holders, out of future earnings) and the rights, if any, of holders in the event of default, including the effect, if any, on junior securities in the event a required dividend, sinking fund, or other redemption payment(s) is not made;
 - (2) the combined aggregate amount of redemption requirements for all issues each year for the five years following the date of the latest balance sheet; and
 - (3) the changes in each issue for each period for which a statement of comprehensive income is required to be filed. (See also § 210.4-08(d).)
- d. Securities reported under this caption are not to be included under a general heading "stockholders' equity" or combined in a total with items described in captions 29, 30 or 31 which follow.



Excerpt from SAB Topic 6.B

Accounting Series Release 280—General Revision Of Regulation S-X: Income Or Loss Applicable To Common Stock

Facts: A registrant has various classes of preferred stock. Dividends on those preferred stocks and accretions of their carrying amounts cause income applicable to common stock to be less than reported net income.

Question: In ASR 280, the Commission stated that although it had determined not to mandate presentation of income or loss applicable to common stock in all cases, it believes that disclosure of that amount is of value in certain situations. In what situations should the amount be reported, where should it be reported, and how should it be computed?

Interpretive Response: Income or loss applicable to common stock should be reported on the face of the income statement^{FN1} when it is materially different in quantitative terms from reported net income or loss^{FN2} or when it is indicative of significant trends or other qualitative considerations. The amount to be reported should be computed for each period as net income or loss less: (a) dividends on preferred stock, including undeclared or unpaid dividends if cumulative; and (b) periodic increases in the carrying amounts of instruments reported as redeemable preferred stock (as discussed in Topic 3.C) or increasing rate preferred stock (as discussed in Topic 5.Q).

FN1 When a registrant reports net income and the total comprehensive income in one continuous financial statement, the registrant must continue to follow the guidance set forth in the SAB Topic. One approach may be to provide a separate reconciliation of net income to income available to common stock below comprehensive income reported on a statement of income and comprehensive income.

FN2 The assessment of materiality is the responsibility of each registrant. However, absent concerns about trends or other qualitative considerations, the staff generally will not insist on the reporting of income or loss applicable to common stock if the amount differs from net income or loss by less than ten percent.



Excerpt from ASC 505-10

> Redeemable Securities

50-11 An entity that issues redeemable stock shall disclose the amount of redemption requirements, separately by issue or combined, for all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the five years following the date of the latest statement of financial position presented.

7. SEC guidance on redeemable equity-classified instruments

The temporary equity presentation and disclosure guidance is included in several locations, including Section 480-10-S99, Regulation S-X and SEC Staff Accounting Bulletins.

The following presentation and disclosure requirements are for SEC registrants and other companies that apply the temporary equity guidance.

Presentation

- Temporary equity instruments are presented separate from shareholders' equity and not included in any equity subtotal.
- Temporary equity instruments are not presented in liabilities.
- Temporary equity instruments may be aggregated on the face of the balance sheet; however, the title, carrying amount, redemption amount, dollar amount of any shares subscribed but unissued, and deduction of subscriptions receivable therefrom for each issuance, must be disclosed in the notes to the financial statements.

If the subsequent measurement of temporary equity securities causes income or loss applicable to common shares to be materially different from the reported net income or loss, the issuer separately presents income or loss applicable to common shares on the face of the financial statements. [SAB Topic 6.B]

Disclosure [505-10-50-11, 480-10-S99-3A, S-X Rule 5-02, CFRR 211.04]

- Disclose the accounting method used to adjust the redemption amount (see section 7.3.30).
- Disclose the currently redeemable amount if the accretion method (Model 2) is used.
- If a redeemable security is not adjusted to its redeemable value, disclose the reasons why the issuer believes it is not probable that the security will become redeemable.

These disclosures are made in a separate note titled 'Redeemable Preferred Shares' to demonstrate these instruments are separate from shareholders' equity. Within that note:

- describe each issuance including its redemption features, and rights of holders in the event of a default;
- disclose the aggregate amount of redemption requirements for each issuance of the subsequent five years from the latest balance sheet date; and
- disclose changes of each issuance for every period there is a statement of comprehensive income required to be filed.

Lastly, if there is a deconsolidation of a subsidiary, disclose the amount credited to equity by the parent.



Question 7.5.10

Do the disclosure requirements for redeemable securities apply to redeemable instruments other than equity shares?

Interpretive response: Yes. The disclosures for redeemable securities apply to all instruments classified as temporary equity, including, but not limited to, common or preferred shares and equity-classified derivative instruments whose redemption is outside the issuer's control.

In contrast, those disclosures do not apply to instruments that are in the scope of Topic 480, including mandatorily redeemable preferred shares classified as a liability and certain items classified as a liability similar to mandatorily redeemable preferred shares, such as put warrants.

Stock options

An issuer discloses the redemption amount of book value stock options classified similarly to redeemable preferred shares if the book value stock plan includes conditions under which the issuer must redeem the shares for cash. See section 3 of KPMG Handbook, [Share-based payment](#), for discussion of book value stock plans.



Question 7.5.20

If there are no scheduled redemption dates, can the issuer disclose the redemption terms instead of the five-year table?

Background: Paragraph 505-10-50-11 requires disclosure of the amount of redemption requirements for all capital stock instruments that are redeemable at fixed or determinable prices on fixed or determinable dates for the five years after the date of the latest statement of financial position. The disclosure requirements in Topic 505 apply to all entities (SEC registrants and others).

SEC registrants must also disclose the combined aggregate amount of redemption requirements for all issues each year for the five years following the latest reporting date. [\[S-X Rule 5-02.27\(c\)\]](#)

Interpretive response: Yes. Similar to how the redemption features of certain instruments are outside of the control of the issuer, the exact dates of redemption are often outside the control of the issuer.

In these cases, instead of estimating future earnings that could allow holders to redeem the instrument or trying to predict actions of the holders, we believe it is appropriate to disclose the redemption provisions instead of the five-year table.



Question 7.5.30

Can temporary equity be included in the Statement of changes of shareholders' equity?

Background: Reg S-X Rule 3-04 requires registrants to reconcile total equity at the beginning of the period to total equity at the end of the period either in the statement of changes of shareholders' equity or a note.

Interpretive response: No. The SEC prohibits including redeemable equity in any caption titled 'total equity'.

While redeemable equity is not permanent equity, it is considered equity for US GAAP purposes. However, registrants with redeemable NCI, redeemable preferred shares or other redeemable equity-classified instruments outside permanent equity cannot include these items in any total or subtotal caption titled 'total equity'. The renaming of the caption in the statement of changes in shareholders' equity 'total equity' to 'total' does not make the inclusion of redeemable equity acceptable. [\[CAQ 06/2009\]](#)

8. Contracts in an entity's own equity

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

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Questions

- 8.2.10 How does an entity determine whether an equity-linked financial instrument is in the scope of Subtopic 815-40?
- 8.2.20 How are embedded features analyzed under the Subtopic 815-40 decision tree?
- 8.2.30 How are freestanding instruments analyzed under the Subtopic 815-40 decision tree?
- 8.2.40 Are embedded features in hybrid instruments in the scope of Subtopic 815-40?
- 8.2.50 Are contracts issued to compensate grantees in a share-based payment arrangement in the scope of Subtopic 815-40?
- 8.2.60 Does Subtopic 815-40 apply to nonemployee share-based payment awards in periods before adopting ASU 2018-07?
- 8.2.70 Are a written put option and a purchased call option for a fixed price embedded in the shares of a consolidated subsidiary's NCI in the scope of Subtopic 815-40?
- 8.2.80 What is the interaction between Topic 480 and Subtopic 815-40?
- 8.2.90 How is an equity-linked financial instrument analyzed if its payoff is based on the stock of a subsidiary?

- 8.2.100 Is an embedded conversion option in a debt issued by a subsidiary in the scope of Subtopic 815-40 if it is convertible into the parent's stock?
- 8.2.110 Is an equity-linked financial instrument that is contingently issuable in the scope of Subtopic 815-40?
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Example

- 8.2.10 Equity-linked financial instruments with payoff based on the stock of a consolidated subsidiary

8.3 Unit of account**Question**

- 8.3.10 What are the units of account if an equity-linked financial instrument is subject to a registration payment arrangement?

8.4 Common equity-linked financial instruments

- 8.4.10 Options
- 8.4.20 Forward contracts
- 8.4.30 Conversion features
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- 8.5.10 Contract terms that can affect the analysis under Subtopic 815-40

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- 8.6.10 Overview

- 8.6.20 The indexation guidance
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Questions

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8.7 Step 1 of the indexation guidance – evaluating contingent exercise provisions

Questions

- 8.7.10 What is a contingent exercise provision?
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- 8.7.30 What are example contingent exercise provisions that would pass or fail Step 1 of the indexation guidance?

Example

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- 8.8.30 Adjustments to the settlement amount
- 8.8.40 Evaluating adjustments to the settlement amount based on explicit inputs
- 8.8.50 Evaluating adjustments to the settlement amount based on implicit inputs
- 8.8.60 Other considerations when evaluating an instrument under Step 2 of the indexation guidance

Questions

- 8.8.10 When is a settlement provision fixed-for-fixed?
- 8.8.20 Is the probability of an adjustment to the settlement amount considered in applying Step 2 of the indexation guidance?
- 8.8.30 Can an equity-linked financial instrument meet Step 2 of the indexation guidance if it contains a provision that adjusts the settlement amount?
- 8.8.40 What is the meaning of 'commercially reasonable'?
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- 8.8.60 Can an equity-linked financial instrument meet Step 2 of the indexation guidance if it contains a provision that adjusts the settlement amount?
- 8.8.70 What are the inputs that are used in determining the fair value of a fixed-for-fixed forward or option contract?
- 8.8.75 Do settlement amount adjustments based on the price of a change-in-control transaction preclude equity-linked instruments from being considered indexed to the entity's own stock?
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- 8.8.90 Can an option on an entity's own equity be considered indexed to the entity's own stock if the payoff amount is determined based on fair value?
- 8.8.100 Is an option precluded from being considered indexed to the entity's own stock if the settlement amount is calculated using a fixed, predetermined or flat volatility?
- 8.8.110 What are some example settlement adjustments that are inconsistent with a fixed-for-fixed contract?
- 8.8.120 What are some common adjustments to implicit inputs that are permitted or prohibited under the indexation guidance?
- 8.8.130 Does the existence of a bail-in provision preclude an equity-linked financial instrument from being considered indexed to the entity's own stock?
- 8.8.140 Does a conversion ratio adjustment feature for third-party tender offers in a convertible debt indenture preclude the feature from being considered indexed to the entity's own stock?
- 8.8.150 What is a down-round feature and how does it differ from a standard antidilution provision?
- 8.8.160 Does the existence of a down-round feature in and of itself cause an equity-linked financial instrument to fail the indexation guidance?
- 8.8.170 Is an adjustment to an instrument's strike price upon the downward revision of the strike price of another of the entity's outstanding instruments a down-round feature?
- 8.8.180 Is a provision that reduces the instrument's strike price and simultaneously increases the number of shares to which the holder will be entitled considered a down-round feature?
- 8.8.185 Would a 'Most Favored Nations' clause impact classification of an equity-linked or hybrid financial instrument? **

- 8.8.190 How does an issuer consider a settlement feature of an equity-linked financial instrument that permits delivery of unregistered shares? **
- 8.8.200 How is the issuer's ability to modify an equity-linked financial instrument analyzed under the indexation guidance?
- 8.8.210 How is the indexation guidance affected if an equity-linked financial instrument's strike price is denominated in a foreign currency?
- 8.8.220 How is a warrant to purchase a fixed number of convertible preferred shares for a fixed amount of cash analyzed under the indexation guidance?
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Examples

- 8.8.10 Fixed-for-fixed settlement provision
- 8.8.20 Possible adjustments to the settlement amount
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- 8.8.40 Warrant's settlement amount is adjusted to a fixed percentage of the entity's outstanding stock at the time of settlement
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- 8.8.80 Equity-linked financial instrument with a standard antidilution provision
- 8.8.90 Equity-linked financial instrument with a down-round provision
- 8.8.100 Evaluating a discount to deliver unregistered shares under Step 2 of the indexation guidance in Subtopic 815-40 **

- 8.8.110 Strike price not denominated in the entity's functional currency
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8.9 Interaction between Step 1 and Step 2 of the indexation guidance

Question

- 8.9.10 How is the unit of account guidance considered when determining whether a provision is a contingent exercise provision or an adjustment to the settlement amount?

Examples

- 8.9.10 Contingent exercise provision or adjustment to the settlement amount?
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- 8.10.10 Overview
- 8.10.20 Settlement alternatives that differ in gain and loss positions
- 8.10.30 Evaluating substance over form

Questions

- 8.10.10 What is the basic premise of the equity classification guidance?
- 8.10.20 How is the equity classification guidance generally affected by standard ISDA provisions often found in equity-linked financial instruments?
- 8.10.30 Does a settlement provision that differs when an equity-linked financial instrument is in a gain or loss position preclude equity classification?

Example

- 8.10.10 Settlement alternatives for an equity-linked financial instrument

8.11 Equity classification guidance – situations in which cash settlement is permitted

Questions

- 8.11.10 How does an entity determine whether an event is solely within its control?
- 8.11.15 When can an instrument meet the equity classification requirements if it permits cash settlement when the holders of the underlying shares receive cash?

- 8.11.20 Does an instrument that is puttable upon a fundamental transaction meet the requirements of the equity classification guidance?
- 8.11.30 Does an instrument that requires the entity to pay cash in lieu of fractional shares upon settlement fail the requirements of the equity classification guidance?
- 8.11.40 Does a warrant that requires the entity to pay stamp, transfer, government or similar taxes fail the requirements of the equity classification guidance?
- 8.11.50 Must an instrument's holders be able to choose the form of consideration for the consideration to be the 'same' if the holders of the instrument's underlying shares can choose?

Example

- 8.11.10 Classification of warrants with tender offer provision by issuer with two classes of voting common shares

8.12 The equity classification guidance – additional conditions

- 8.12.10 Overview
- 8.12.20 Additional Condition #1: Entity has sufficient authorized and unissued shares
- 8.12.30 Additional Condition #2: Contract contains an explicit share limit
- 8.12.40 Additional Condition #3: No required cash payments if the entity fails to timely file with the SEC
- 8.12.50 Additional Condition #4: No cash-settled top-off or make-whole provisions

Questions

- 8.12.05 [Not used]
- 8.12.10 What provisions are not considered when evaluating net-cash settlement?
- 8.12.20 What does an entity need to consider if a contract requires settlement in registered shares?
- 8.12.30 Do master netting arrangements covering both equity- and nonequity-classified contracts preclude equity classification?
- 8.12.40 How does an entity account for an equity-linked financial instrument when it does not have sufficient authorized and unissued shares for settlement?
- 8.12.50 How does an entity determine whether it has sufficient authorized and unissued shares for settlement?
- 8.12.60 How does an entity determine the number of shares in its calculation of authorized and unissued shares if an instrument permits the issuer or holder to choose the settlement method?

- 8.12.65 Is additional Condition #1 met if an equity-linked financial instrument's terms specify that the entity is not required to net-cash settle it even if there are insufficient authorized and unissued shares?
- 8.12.70 How does an entity evaluate whether an instrument passes additional Condition #1 if the entity is required to issue shares upon the occurrence of a specified event?
- 8.12.80 How does an entity evaluate whether an instrument passes additional Condition #1 if it has multiple equity-linked financial instruments?
- 8.12.90 Does a stock exchange's '20% rule' affect whether an equity-linked financial instrument subject to the rule meets additional Condition #1?
- 8.12.100 How does an explicit or implicit share limit affect additional Condition #2?
- 8.12.110 How does a provision obligating an entity to use its best efforts to authorize sufficient shares for settlement affect additional Condition #2?
- 8.12.120 How does an entity evaluate an equity-linked financial instrument that has multiple share caps?
- 8.12.130 Does an instrument fail additional Condition #3 if the entity must make a penalty payment if it fails to timely file with the SEC?
- 8.12.140 What is the difference between a make-whole provision and 'make-whole shares'?
- 8.12.150 Does the existence of a 'buy-in' provision cause an instrument to fail the requirements of the equity classification guidance? #

Examples

- 8.12.10 Uneconomic settlement alternatives in an equity-linked financial instrument
- 8.12.20 Warrant with a share cap
- 8.12.30 Equity-linked financial instrument with no share limit
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8.13 Initial and subsequent classification and measurement

- 8.13.10 Overview
- 8.13.20 When the requirements of Subtopic 815-40 are not met
- 8.13.30 When the requirements of Subtopic 815-40 are met

- 8.13.40 Modifications or exchanges of freestanding equity-classified written call options

Questions

- 8.13.10 How is an embedded feature accounted for when it does not meet the requirements of Subtopic 815-40?
- 8.13.20 How is a freestanding instrument accounted for when it does not meet the requirements of Subtopic 815-40?
- 8.13.30 How is an equity-classified embedded feature accounted for when it meets the requirements of Subtopic 815-40?
- 8.13.40 How is a freestanding instrument accounted for when it meets the requirements of Subtopic 815-40?
- 8.13.50 How is a freestanding equity-classified instrument accounted for if it was issued with other instruments as part of a single transaction?
- 8.13.60 Which modifications or exchanges of written call options does Subtopic 815-40 provide guidance for?
- 8.13.70 How does an entity measure and recognize the effect of a modification or exchange of a freestanding equity-classified written call option?
- 8.13.80 What factors are considered when determining the nature of a modification or exchange of a freestanding equity-classified written call option?
- 8.13.90 What disclosures are required for a modification or exchange of a freestanding equity-classified written call option?

8.14 Reclassification of instruments

Questions

- 8.14.10 What are examples of events that could cause an instrument to be reclassified?
- 8.14.20 How is the reclassification of a freestanding instrument accounted for?
- 8.14.30 How is the reclassification of an embedded feature accounted for?
- 8.14.40 Once an entity has sufficient authorized and unissued shares to justify equity classification of an instrument, does it reclassify the instrument?
- 8.14.50 When an entity has more than one equity-classified instrument under Subtopic 815-40, how does it determine which instruments may require reclassification?
- 8.14.60 When an antidilution provision is triggered, does an entity reclassify warrants from equity to liability if it pays cash to the warrant holders?

Example

- 8.14.10 Reclassification of multiple equity-linked financial instruments

8.15 Derecognition

- 8.15.10 Overview
- 8.15.20 Settlement of equity-classified instruments
- 8.15.30 Settlement of asset- or liability-classified instruments

Questions

- 8.15.10 How is an equity-linked financial instrument's settlement accounted for if it is classified as equity?
- 8.15.20 How is an equity-linked financial instrument's settlement accounted for if it is classified as an asset or liability?

Examples

- 8.15.10 Settlement of a freestanding warrant that is classified as equity
- 8.15.20 Settlement of a freestanding warrant that is classified as a liability

8.16 Applicability of Subtopic 815-40 to certain instruments

- 8.16.10 Certain convertible debt instruments
- 8.16.20 Certain freestanding instruments
- 8.16.30 Accelerated share repurchase programs
- 8.16.40 [Not used]

Questions

- 8.16.10 What are some examples of convertible instruments that qualify for the exception in paragraph 815-40-25-39, and some that do not?
- 8.16.20 What are some common provisions that would cause an ASR's forward contract to fail the equity classification requirements of Subtopic 815-40?

Example

- 8.16.10 Convertible debt where additional conditions for equity classification do not apply

8.17 Presentation and disclosure

8.1 How the standard works

How a contract is treated for accounting purposes when it is indexed to, and potentially settled in, an entity's own stock is addressed by Subtopic 815-40 (contracts in an entity's own equity).

The following instruments are in the scope of Subtopic 815-40.

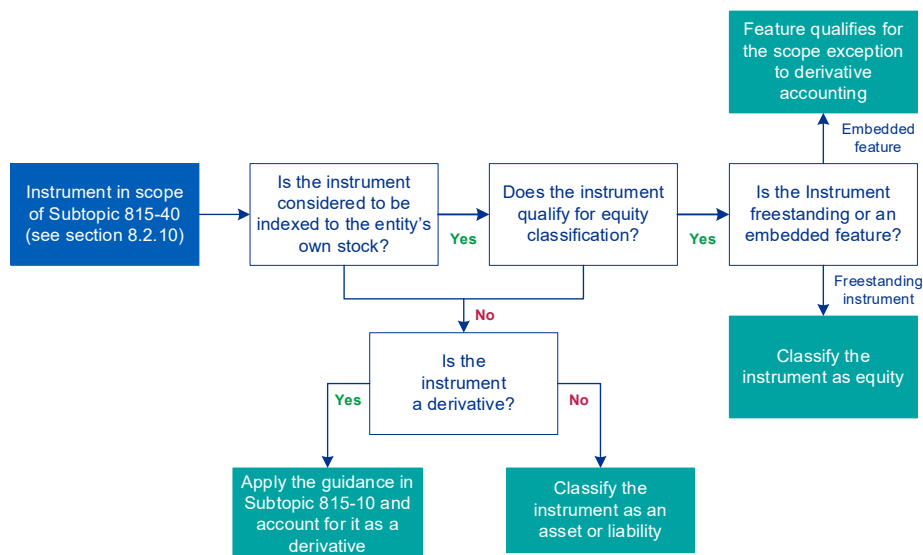
- Embedded features that have all of the characteristics of a derivative instrument and otherwise meet the requirements to be bifurcated under Subtopic 815-15 – before considering whether it qualifies for the own equity scope exception from derivative accounting.
- Freestanding financial instruments that are potentially settled in an entity's own stock that are not in the scope of Topic 480 (chapter 6) – regardless of whether they have all of the characteristics of a derivative instrument.

Instruments in the scope of Subtopic 815-40 are referred to throughout this chapter as 'equity-linked financial instruments'.

To determine the accounting treatment of equity-linked financial instruments under Subtopic 815-40, they are analyzed against two criteria.

- The indexation guidance determines whether an instrument is considered indexed to the entity's own stock.
- The equity classification guidance determines whether the entity is required or is permitted to settle an instrument in its own shares (either physically or net in shares).

These two criteria and the additional steps in determining the appropriate accounting for an equity-linked financial instrument or feature are illustrated in the following decision tree.



Effect of ASU 2020-06

The ASU affected this chapter because it amended the requirements for a contract (or embedded derivative) that is potentially settled in an entity's own shares to be classified in equity.

Specifically, before the ASU, Subtopic 815-40 included seven additional conditions that had to be met for a contract to be classified in equity (or for an embedded derivative to meet the derivative scope exception) because they may (or will) result in the contract being settled in cash rather than shares. The ASU removed three of those conditions and clarified another, as summarized in the following table.

Removed conditions	Clarified condition
<p>An entity is no longer required to consider whether:</p> <ul style="list-style-type: none"> — settlement is permitted in unregistered shares (unless the contract explicitly requires settlement in cash if registered shares are not available); — collateral is required to be posted; or — counterparty rights rank higher than shareholder rights. 	<p>A penalty payment from the failure to make timely filings with the SEC does not preclude equity classification.</p>

See section 8.12 for details of the equity classification requirements.

8.2 Scope of Subtopic 815-40

8.2.10 Overview



Excerpt from ASC 815-40

05-1 For a number of business reasons, an entity may enter into contracts that are indexed to, and sometimes settled in, its own stock. This Subtopic provides guidance on accounting for such contracts. Examples of these contracts include put and call options (both written and purchased) and forward contracts (for both sales and purchases). These contracts may be settled using a variety of settlement methods, or the issuing entity or counterparty may have a choice of settlement methods. The contracts may be either freestanding or embedded in another **financial instrument**.

> Entities

15-1 The guidance in this Subtopic applies to all entities.

> Instruments

15-2 The guidance in this Subtopic applies to **freestanding contracts** that are potentially indexed to, and potentially settled in, an entity's own stock.

15-2A The scope of this Subtopic includes security price guarantees or other **financial instruments** indexed to, or otherwise based on, the price of the entity's stock that are issued in connection with a business combination and that are accounted for as contingent consideration.

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

15-5 The guidance in this paragraph through paragraph 815-40-15-8 applies to any **freestanding financial instrument** or embedded feature that has all the characteristics of a **derivative instrument** (see the guidance beginning in paragraph 815-10-15-83). That guidance applies for the purpose of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 815-10-15-74(a). That guidance does not address the second part of the scope exception in paragraph 815-10-15-74(a), which is addressed in Section 815-40-25. The guidance also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative instrument for purposes of determining whether the instrument is within the scope of this Subtopic.



Excerpt from ASC 815-10

• • > Certain Contracts Involving an Entity's Own Equity

15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- a. Contracts issued or held by that reporting entity that are both:
 1. Indexed to its own stock (see Section 815-40-15)
 2. Classified in stockholders' equity in its statement of financial position (see Section 815-40-25).

15-75 The scope exceptions in the preceding paragraph do not apply to either of the following:

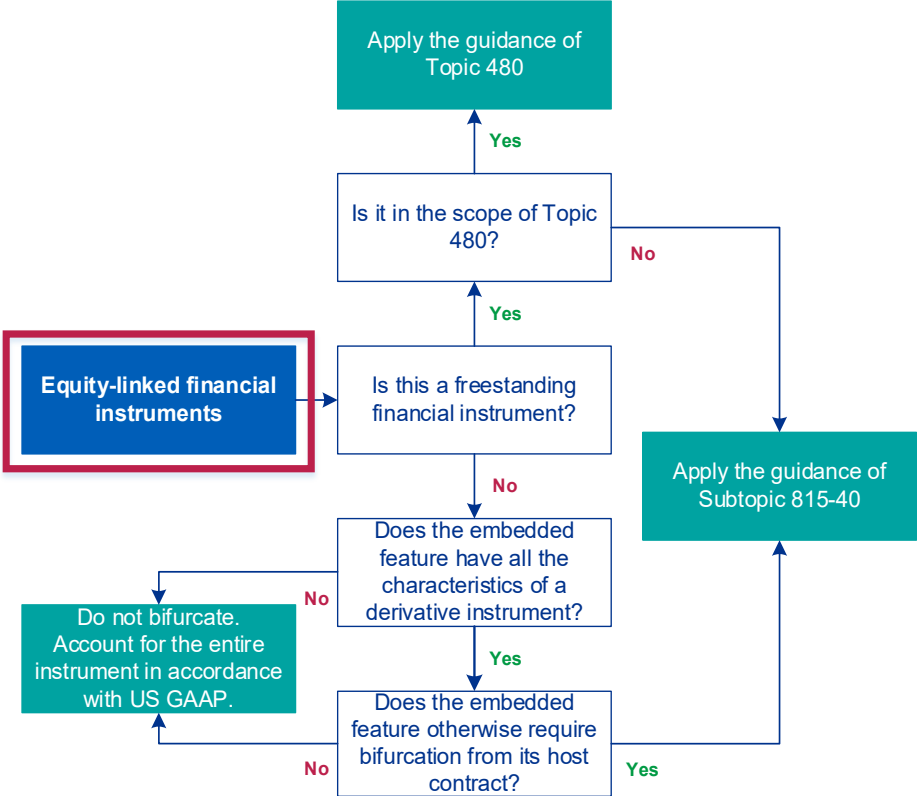
- a. The counterparty in those contracts. For example, the scope exception in (b) in the preceding paragraph related to stock-based compensation arrangements does not apply to equity instruments (including stock options) received by nonemployees as compensation for goods and services.
- b. A contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock. That contract can be a derivative instrument for the issuer under paragraphs 815-10-15-13 through 15-139, in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Subtopic. For example, a forward contract that is indexed to both an entity's own stock and currency exchange rates does not qualify for the exception in (a) in the preceding paragraph with respect to that entity's accounting because the forward contract is indexed in part to something other than that entity's own stock (namely, currency exchange rates).

Financial instruments that are analyzed under Subtopic 815-40 are referred to in this Handbook as 'equity-linked financial instruments'.

Subtopic 815-40 applies only to equity-linked financial instruments that are issued (i.e. written) or held (i.e. purchased) by the reporting entity; the guidance does not apply to the counterparty to the instrument. When analyzing an equity-linked financial instrument, care must be taken to identify both the entity issuing and holding the instrument, and the entity's stock to which the contract is indexed.

Question 8.2.10
How does an entity determine whether an equity-linked financial instrument is in the scope of Subtopic 815-40?

Interpretive response: The following decision tree summarizes the process for determining whether an equity-linked financial instrument is in the scope of Subtopic 815-40 (start at the blue box on the left).



The decision tree is used to analyze the following types of financial instruments that can potentially be settled in the entity's own equity:

- embedded features that have all of the characteristics of a derivative instrument and otherwise meet the requirements to be bifurcated – before considering whether they qualify for the own equity scope exception from derivative accounting (see Question 8.2.20)
- freestanding financial instruments that are potentially settled in an entity's own stock, regardless of whether they have all the characteristics of a derivative instrument.



Question 8.2.20

How are embedded features analyzed under the Subtopic 815-40 decision tree?

Interpretive response: An embedded feature is first analyzed under Subtopic 815-10 to determine if it meets the requirements for derivative accounting (see section 9.2). To qualify for derivative accounting, an embedded feature must meet all of the following criteria: [\[815-15-25-1\]](#)

- the economic characteristics and risks of the embedded derivative are not clearly and closely related to its host contract (the 'clearly and closely related test');
- the instrument in which the feature is embedded is not measured at fair value; and
- a separate instrument with the same terms as the embedded feature would be a derivative instrument subject to the requirements of derivative accounting.

If an embedded feature meets the requirements for derivative accounting and the feature can potentially be settled in the entity's own equity, it is analyzed under Subtopic 815-40 to determine if it qualifies for the own equity scope exception from derivative accounting.

This scope exception applies only to instruments that are both:

- indexed to the entity's own stock; and
- classified as equity on the entity's balance sheet.

If an embedded feature meets this scope exception, it is not bifurcated from the host instrument even if it fails the clearly and closely related test, and is precluded from being recorded and subsequently measured as a derivative asset or liability. [\[815-10-15-74\(a\)\]](#)

This scope exception does not apply to embedded features that are indexed, either in part or in full, to something other than the entity's share price – e.g. interest rates, currency exchange rates. [\[815-10-15-75\(b\)\]](#)



Question 8.2.30

How are freestanding instruments analyzed under the Subtopic 815-40 decision tree?

Interpretive response: If a freestanding financial instrument can potentially be settled in the entity's own equity, it is analyzed under Subtopic 815-40 regardless of whether it meets the definition of a derivative under Subtopic 815-10.

- **Meets the definition of a derivative.** If a freestanding financial instrument meets all the characteristics of a derivative, Subtopic 815-40 determines whether the own equity scope exception from derivative accounting applies. If it meets this scope exception, it is recorded and initially

measured as equity, as opposed to a derivative asset or derivative liability. Section 9.3.50 discusses the characteristics of a derivative. [815-10-15-74(a)]

- **Does not meet the definition of a derivative.** If a freestanding financial instrument does not meet all the characteristics of a derivative, the entity still applies Subtopic 815-40 to determine if it is required to classify the instrument as equity. The following are examples of this type of instrument:
 - a freestanding warrant that requires physical settlement in a private company's shares;
 - a private company entering into a forward contract to issue its own shares in exchange for cash (i.e. physical settlement).

Such instruments do not meet the net settlement characteristic to be considered a derivative under Subtopic 815-10, but they are still analyzed under Subtopic 815-40 to determine whether they are required to be classified as equity.

The own equity scope exception from derivative accounting does not apply to freestanding instruments that are indexed (in part or in full) to something other than the entity's share price – e.g. interest rates or currency exchange rates.

[815-10-15-75]

8.2.20 Scope exceptions to Subtopic 815-40



Excerpt from ASC 815-40

> Instruments

15-3 The guidance in this Subtopic does not apply to any of the following:

- a. Subparagraph superseded by Accounting Standards Update No. 2020-06.
- b. Contracts that are issued to compensate grantees in a share-based payment arrangement within the scope of Topic 718
- c. Subparagraph superseded by Accounting Standards Update No. 2018-07
- d. A written put option and a purchased call option embedded in the shares of a noncontrolling interest of a consolidated subsidiary if the arrangement is accounted for as a financing under the guidance beginning in paragraph 480-10-55-53
- e. Financial instruments that are within the scope of Topic 480 (see paragraph 815-40-15-12).

15-4 The guidance in this Subtopic applies to derivatives embedded in contracts in analyzing the embedded feature under paragraphs 815-15-25-1(c) and 815-15-25-14 as though it were a freestanding instrument (as further discussed in paragraphs 815-40-25-39 through 25-40).

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

15-5A The guidance in this paragraph through paragraph 815-40-15-8 does not apply to share-based payment awards within the scope of Topic 718 for purposes of determining whether instruments are classified as liability awards or equity awards under that Topic. Equity-linked financial instruments issued to

investors for purposes of establishing a market-based measure of the grant-date fair value of employee stock options are not within the scope of Topic 718 themselves. Consequently, the guidance in this paragraph through paragraph 815-40-15-8 applies to such market-based share-based payment stock option valuation instruments for purposes of making the determinations described in paragraph 815-40-15-5.

> Other Considerations

• > Distinguishing Liabilities from Equity

15-12 Paragraph 480-10-15-5 explains that Topic 480 does not apply to a feature embedded in a financial instrument that is not a derivative instrument in its entirety (for example, a written put option embedded in a nonderivative host contract) in analyzing the embedded feature as though it were a separate instrument as required by paragraph 815-15-25-1(c). Therefore, this Subtopic applies in evaluating those embedded features under Subtopic 815-15.

The exceptions to the scope of Subtopic 815-40 are listed in the above excerpt and are discussed in this section. An instrument that falls under one of these scope exceptions is analyzed under other US GAAP to determine its balance sheet classification. Therefore, there is no need to apply Subtopic 815-40 to determine if it meets the own equity scope exception from derivative accounting. [815-40-15-3]



Question 8.2.40

Are embedded features in hybrid instruments in the scope of Subtopic 815-40?

Background: A hybrid instrument is a contract that embodies both an embedded feature and a host contract. An instrument (or a feature embedded in a hybrid instrument) must have all of the following characteristics to be a derivative: [815-10-15-83]

- includes both an underlying and a notional amount or payment provision;
- requires no initial net investment, or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- requires or permits net settlement.

For an embedded feature to be separated from its host contract and accounted for as a derivative instrument, the following criteria must be met: [815-15 Glossary, 815-15-25-1]

- the embedded feature must not be clearly and closely related to the host contract (see section 9.3.60);
- the hybrid instrument must not be measured at fair value with changes in fair value recognized in earnings as they occur; and

- the embedded feature would meet the definition of a derivative if it were a separate instrument with the same terms and be subject to the requirements of Subtopics 815-10 and 815-15 (see section 9.3.50).

Section 9.3 further discusses how to determine whether an embedded feature is required to be bifurcated from the host contract.

Interpretive response: It depends on whether the embedded feature would meet the definition of a derivative if it were a separate instrument that is indexed to an entity's own equity, and if it does, whether it would be required to be separated from the host contract. Under the first scope exception, Subtopic 815-40 does not apply to an instrument that includes an embedded feature that does not meet the requirements of Subtopic 815-15 (embedded derivatives) for bifurcation from the host contract. Instead, other US GAAP applies to the entire instrument. [815-40-15-3(a), 15-4]

For these embedded features, derivative accounting does not apply. Therefore, there is no need to determine if they fall under the own equity scope exception from derivative accounting in Subtopic 815-40.

For example, if the host contract in a convertible preferred stock instrument is considered an equity host, the embedded equity conversion option will be clearly and closely related. Therefore, analysis under Subtopic 815-40 is not applicable because the embedded conversion option is already exempt from being separated from its host contract and accounted for as a derivative.

Another example is a convertible debt issued by a private entity. The embedded conversion option (which is primarily indexed to the equity value of the entity) would not be clearly and closely related to the debt host contract. However, because a private entity's shares are not readily convertible to cash, one of the characteristics of a derivative – that the instrument can be net settled – is not met. As a result, the embedded feature is not bifurcated from the host instrument, and therefore it is not in the scope of Subtopic 815-40.



Question 8.2.50

Are contracts issued to compensate grantees in a share-based payment arrangement in the scope of Subtopic 815-40?

Interpretive response: No. The second scope exception to Subtopic 815-40 is for contracts that are issued to grantees in a share-based payment arrangement (including both employee and nonemployee awards). Share-based payment arrangements include the issuance of shares, share options or other equity instruments in exchange for services provided to the entity. The guidance for determining whether such an arrangement is accounted for as a liability or as equity is included in Topic 718 (stock compensation). [815-40-15-3(b), 15-5A, 718-10 Glossary]

However, a share-based payment arrangement may fall under the scope of Subtopic 815-40, or other guidance, in certain situations.

- If a share-based payment arrangement with an employee is modified after they are no longer an employee (e.g. due to retirement) and the award is

vested, the arrangement may be in the scope of Subtopic 815-40 if it is not in the scope of Topic 480; see Question 8.2.80 for the interaction between Topic 480 and Subtopic 815-40. See Example 1.1c in KPMG Handbook, [Share-based payment](#), for an illustration of this scenario. [718-10-35-10]

- Once performance on share-based payment arrangements with nonemployees is complete, the arrangement may be subject to Topic 480 or Subtopic 815-40 if the award is modified. [718-10-35-10, 35-12 – 35-14]
- When there is a convertible instrument award granted to a nonemployee in exchange for goods or services, upon vesting the award is subject to the recognition and measurement provisions of Subtopic 470-20. [718-10-35-9A]

Careful analysis is required when an arrangement is modified, because there are certain exceptions to what is considered a modification of a share-based payment arrangement when determining whether Topic 718 continues to apply. See section 5 of KPMG Handbook, [Share-based payment](#), for guidance on modifications to employee share-based payment arrangements. [718-10-35-10 – 35-12]



Question 8.2.60

Does Subtopic 815-40 apply to nonemployee share-based payment awards in periods before adopting ASU 2018-07?

Background: In June 2018, the FASB issued ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting. The ASU eliminates the separate accounting model for nonemployee share-based payment awards included in Subtopic 505-50. It revises Topic 718 to require entities to account for these awards in the same way as share-based payment transactions with employees – with the exception of attribution and a specific contractual term election for valuing nonemployee equity share options.

The ASU is fully effective for public business entities. For other entities, it is effective for fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted, but no earlier than the entity's adoption date of Topic 606 (revenue).

Interpretive response: Nonemployee share-based payment awards are subject to either Subtopic 505-50 or Topic 718, depending on whether ASU 2018-07 is adopted. This is because ASU 2018-07 eliminates the separate accounting model for nonemployee share-based payment awards included in Subtopic 505-50. Further, there is revised guidance on when nonemployee share-based payment awards become subject to other guidance (e.g. Topic 480 or Subtopic 815-40) pre- and post-adoption of ASU 2018-07. The following table summarizes the interaction of ASU 2018-07 with Subtopic 815-40.

Has the entity adopted ASU 2018-07?	815-40 scope exception [815-40-15-3(b), 15-3(c)]	When do nonemployee share-based payment awards become subject to other guidance, including Subtopic 815-40?
No (nonemployee awards accounted for under Subtopic 505-50)	Subtopic 815-40 includes the following scope exceptions: <ul style="list-style-type: none"> — contracts that are issued to compensate employees — contracts issued to acquire goods or services from nonemployees when performance has not yet occurred. 	Once the nonemployee award is vested and no further performance is required under the nonemployee share-based payment arrangement.
Yes (nonemployee awards accounted for under Topic 718)	Subtopic 815-40 does not apply to contracts that are issued to compensate grantees in a share-based payment arrangement.	Nonemployee awards generally remain subject to Topic 718, unless the award has vested and its terms are modified. Once the vested nonemployee award is modified, it becomes subject to other guidance. [718-10-35-10]



Question 8.2.70

Are a written put option and a purchased call option for a fixed price embedded in the shares of a consolidated subsidiary's NCI in the scope of Subtopic 815-40?

Background: Sometimes a parent and an NCI holder will enter into a derivative instrument on the NCI contemporaneous with the parent's acquisition of the controlling interest in the entity. For example, the parent may have a call option to buy from the NCI holder – and the NCI holder a put option to sell to the parent – the entirety of the NCI at a fixed price at a stated future date – i.e. the fixed price of the call option is equal to the fixed price of the put option. [480-10-55-53]

Interpretive response: It depends on whether the arrangement is accounted for as a financing under Topic 480. The fourth scope exception to Subtopic 815-40 is for written put options and purchased call options embedded in the shares of a consolidated subsidiary's NCI if the arrangement is accounted for as a financing under Topic 480. [815-40-15-3(d)]

If an instrument is accounted for as a financing of the parent's purchase of the NCI, the parent consolidates the subsidiary and no NCI is reflected. If the instrument is accounted for in this manner, it is in the scope of Topic 480.

Therefore, as discussed in Question 8.2.80, it is not in the scope of Subtopic 815-40. [480-10-55-60 – 55-61]

In the example in the above background, the written put option and the purchased call option are accounted for as a financing under Topic 480 if the options are embedded in the NCI shares, and the NCI shares are not otherwise classified as liabilities under Topic 480.

However, if the combination of options is not accounted for as a financing under Topic 480, the arrangement is not excluded from the scope of Subtopic 815-40. For example, sometimes these arrangements are structured such that the strike price of one or both of the options is based on a formula (e.g. a multiple of the subsidiary's EBITDA). In such cases, we believe Topic 480 does not permit accounting for the combination of options as a financing. [480-10-55-61]



Question 8.2.80

What is the interaction between Topic 480 and Subtopic 815-40?

Interpretive response: Subtopic 815-40 excludes from its scope freestanding financial instruments that are in the scope of Topic 480. This scope exception exists because if a freestanding financial instrument is in the scope of Topic 480, it cannot also be in the scope of Subtopic 815-40. As discussed in section 6.2.30, freestanding financial instruments in the scope of Topic 480 are classified as liabilities (or assets in some circumstances) because they embody an obligation of the entity. As a result, a freestanding financial instrument must first be analyzed to determine whether it is in the scope of Topic 480, before analyzing it under Subtopic 815-40. [815-40-15-3(e)]

See chapter 6 for guidance on determining whether an instrument is in the scope of Topic 480. The Subtopic 815-40 excerpt below provides an example of an instrument that is in the scope of Topic 480 as opposed to Subtopic 815-40.



Excerpt from ASC 815-40

- > Put Warrants

55-16 Put warrants are frequently issued concurrently with debt securities of the entity, are detachable from the debt, and may be exercisable only under specified conditions. The put feature of the instrument may expire under varying circumstances, for example, with the passage of time or if the entity has a public stock offering. Under Subtopic 470-20, a portion of the proceeds from the issuance of debt with detachable warrants must be allocated to those warrants.

55-17 Put warrants are instruments with characteristics of both warrants and put options. The holder of the instrument is entitled to do any of the following:

- a. Exercise the warrant feature to acquire the common stock of the entity at a specified price
- b. Exercise the put option feature to put the instrument back to the entity for a cash payment
- c. Exercise both the warrant feature to acquire the common stock and the put option feature to put that stock back to the entity for a cash payment.

55-18 Because the contract gives the counterparty the choice of cash settlement or settlement in shares, entities should report the proceeds from the issuance of put warrants as liabilities and subsequently measure the put warrants at fair value with changes in fair value reported in earnings as required by Topic 480. That is, a put warrant that embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require a transfer of assets is within the scope of that Topic and therefore is to be recognized as a liability.

8.2.30 Equity-linked financial instruments with payoff based on the stock of a consolidated subsidiary



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

15-5C Freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary are not precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity. If the subsidiary is not a substantive entity, the instrument or embedded feature shall not be considered indexed to the entity's own stock. If the subsidiary is considered to be a substantive entity, the guidance beginning in paragraph 815-40-15-5 shall be applied to determine whether the freestanding financial instrument (or an embedded feature) is indexed to the entity's own stock and shall be considered in conjunction with other applicable GAAP (for example, this Subtopic) in determining the classification of the freestanding financial instrument (or an embedded feature) in the financial statements of the entity. The guidance in this paragraph applies to those instruments (and embedded features) in the consolidated financial statements of the parent, whether the instrument was entered into by the parent or the subsidiary. The guidance in this paragraph does not affect the accounting for instruments (or embedded features) that would not otherwise qualify for the scope exception in paragraph 815-10-15-74(a). For example, freestanding instruments that are classified as liabilities (or assets) under Topic 480 and put and call options embedded in a noncontrolling interest that is accounted for as a financing arrangement under Topic 480 are not affected by this guidance. For guidance on presentation of an equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable GAAP) within the scope of the guidance in this paragraph, see paragraph 810-10-45-17A.

A parent entity or its consolidated subsidiary may enter into an equity-linked financial instrument for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary. Examples of such instruments that are freestanding include written or purchased call options (and warrants) on the stock of the consolidated subsidiary. Examples of such instruments that are embedded include convertible debt that is convertible into the stock of the subsidiary.

If the payoff of an equity-linked instrument is based (in whole or in part) on the stock of a consolidated subsidiary, it may still be in the scope of Subtopic 815-40 if the subsidiary is a 'substantive entity'. For example, if the subsidiary is a substantive entity, an embedded option to convert debt into the subsidiary's shares is analyzed under Subtopic 815-40 to determine if the conversion option meets the own equity scope exception from derivative accounting. [815-40-15-5C]



Question 8.2.90

How is an equity-linked financial instrument analyzed if its payoff is based on the stock of a subsidiary?

Background: Topic 810 (consolidation) requires an equity-classified instrument to be presented as a component of NCI in the consolidated financial statements if it is in the scope of paragraph 815-40-15-5C. An equity-classified instrument in this instance includes both a freestanding instrument, and an embedded feature that is separately recorded in equity under applicable US GAAP. This presentation is required regardless of whether the instrument was entered into by the parent or the subsidiary. However, if the instrument was entered into by the parent and expires unexercised, the carrying amount of the instrument is reclassified from NCI to controlling interest. [810-10-45-17A]

Interpretive response: The analysis varies depending on whether the financial instrument is embedded or freestanding.

Embedded features

These Topic 810 requirements apply only if the equity-linked financial instrument is required to be classified as equity. As discussed in Question 8.2.20, the purpose of analyzing an embedded feature under Subtopic 815-40 is to determine whether it qualifies for the own equity scope exception from derivative accounting. Qualifying for this scope exception does not result in the embedded feature being classified in equity; instead, it simply is not bifurcated from its host contract and accounted for separately as a derivative. In this scenario, the requirements of Topic 810 discussed in the background do not apply because the embedded feature is not required to be classified as equity.

However, other US GAAP may require an embedded feature to be separately recorded in equity. For example, certain convertible debt instruments are required to be separated between their liability and equity components (see chapter 10). If such debt is convertible into shares of a consolidated subsidiary, the equity component is presented as a component of NCI in the consolidated financial statements regardless of whether the parent or the consolidated subsidiary issues the debt.

A similar presentation would result in other circumstances in which a conversion option related to a subsidiary's shares is required to be separately accounted for in equity under other applicable US GAAP. However, if a parent issues debt that is convertible into the stock of a consolidated subsidiary and the conversion option is presented as a component of NCI, any amount that remains in equity after either the exercise of the conversion option or the maturity of the convertible debt would be reclassified from NCI to the controlling interest at that time.

Freestanding financial instruments

The purpose of analyzing a freestanding financial instrument under Subtopic 815-40 is to determine whether it should be classified as equity or as a liability (or in some cases an asset). For example, if a subsidiary issues freestanding warrants (that would otherwise qualify for derivative accounting) that meet the own equity scope exception from derivative accounting, they are classified as equity. In this scenario, the subsidiary would present the warrants as a component of equity in its stand-alone financial statements. In the consolidated financial statements, the warrants would be presented as a component of NCI.

This guidance does not apply to instruments that are not eligible for equity classification under other applicable US GAAP (e.g. Topic 480). The guidance also does not apply to a written put option and a purchased call option embedded in the shares of an NCI in a consolidated subsidiary if the arrangement is accounted for as a financing (see Question 8.2.70).

See section 7.5 of KPMG Handbook, [Consolidation](#), for a discussion about accounting for NCI.



Example 8.2.10

Equity-linked financial instruments with payoff based on the stock of a consolidated subsidiary

Scenario 1: Parent issues warrants

On January 1, Year 1, Parent issues warrants that permit Holder to purchase the common shares of Parent's Subsidiary. The warrants have a 20-year term, and are exercisable any time.

Parent concludes that Subsidiary is a substantive entity, and that the warrants meet all the indexation and equity classification requirements of Subtopic 815-40 to be classified in equity.

Therefore, these equity-classified warrants are presented as a component of NCI in Parent's consolidated financial statements.

Scenario 2: Subsidiary issues warrants

Instead of Parent, Subsidiary issues the warrants to purchase its own common shares. The warrants are still presented as a component of NCI in Parent's consolidated financial statements. Therefore, this presentation is required regardless of whether the warrants are entered into by Parent or Subsidiary.



Question 8.2.100

Is an embedded conversion option in a debt issued by a subsidiary in the scope of Subtopic 815-40 if it is convertible into the parent's stock?

Interpretive response: Subtopic 815-40 does not explicitly address conversion options in convertible debt issued by a subsidiary that is convertible into the shares of its parent. We believe the conversion option can still be considered indexed to the entity's (i.e. reporting entity's) own stock in the consolidated financial statements because the consolidated group is considered the reporting entity.

In contrast, in the subsidiary's stand-alone financial statements, the subsidiary is the reporting entity. Because the debt is convertible into another entity's stock, the conversion option is generally not considered indexed to the reporting entity's own stock in the subsidiary's stand-alone financial statements. Therefore, from the perspective of the subsidiary's stand-alone financial statements, the conversion option fails the own equity scope exception from derivative accounting, and must be bifurcated from its host instrument and accounted for under Subtopic 815-15.

We believe the same guidance applies to affiliated entities. For example, Parent has two subsidiaries: Subsidiary A and Subsidiary B. If Subsidiary A issues convertible debt that is convertible into the shares of Subsidiary B, the conversion option may be considered indexed to the entity's own stock in the consolidated financial statements of the Parent but not in Subsidiary A's stand-alone financial statements.

8.2.40 Evaluating whether an instrument or embedded feature is considered issued



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

15-6 The guidance in this paragraph applies to both the issuer and the holder of the instrument. Outstanding instruments within the scope of the guidance in paragraphs 815-40-15-5 through 15-8 shall always be considered issued for accounting purposes, except as discussed in the next sentence. **Lock-up options** shall not be considered issued for accounting purposes unless and until the options become exercisable.



Excerpt from ASC Master Glossary

Lock-Up Options

Contingently exercisable options to purchase equity securities of another party to a business combination, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable.

All equity-linked financial instruments evaluated under Subtopic 815-40 are considered issued, even if they are not yet exercisable. For example, a contingent exercise provision does not preclude an instrument from being considered issued. [815-40-15-6, 15-7A]

Exception for lock-up options

Lock-up options are an exception to the above principle that instruments are considered issued even when not yet exercisable. Specifically, lock-up options are not considered issued until they become exercisable. [815-40-15-6]

Lock-up options are granted to a potential acquirer to purchase a target entity's shares at favorable prices and to prevent the target from being sold to other potential buyers. [Master Glossary]

These options are often granted to promote completion of a business combination between the potential acquirer and the target entity and to deter an undesirable acquirer because of the high value of the options. If the originally contemplated merger occurs, the options expire unexercisable. However, if another specified event occurs (e.g. an offer to acquire the target entity by an undesirable acquirer), the options become exercisable.



Question 8.2.110

Is an equity-linked financial instrument that is contingently issuable in the scope of Subtopic 815-40?

Background: A contingently issuable equity-linked financial instrument is an instrument that an entity agrees to issue at a point in the future, or upon the occurrence of an event – e.g. execution of a business combination, resolution of a contingency, IPO.

Interpretive response: For the purposes of analyzing a contract under Subtopic 815-40, all instruments that meet the scope requirements of the Subtopic (except lock-up options) are always considered to be issued for accounting purposes. [815-40-15-6]

We believe there is no substantive difference between a contingently issuable equity-linked financial instrument such as the one described in the background, and an instrument that has been issued but contains a contingent exercise

provision; see section 8.7 for the definition of a contingent exercise provision. The following instruments illustrate this point.

<p>Instrument #1</p> <p>Contingently issuable</p>	<p>An entity makes a commitment to issue warrants when the entity's share price exceeds \$25 per share</p>
<p>Instrument #2</p> <p>Issued with an exercise contingency</p>	<p>An entity issues warrants that are exercisable only when the entity's share price exceeds \$25 per share</p>

Therefore, we believe an equity-linked financial instrument that is contingently issuable is in the scope of Subtopic 815-40 – assuming it does not meet any of the scope exceptions discussed in section 8.2.20.

8.2.50 Contingent consideration in a business combination



Excerpt from ASC 815-40

> Instruments

15-2A The scope of this Subtopic includes security price guarantees or other **financial instruments** indexed to, or otherwise based on, the price of the entity's stock that are issued in connection with a business combination and that are accounted for as contingent consideration.

Contingent consideration arrangements may be entered into as part of a business combination. They obligate the acquiring entity to provide the former owners of the acquiree with additional assets or equity interests, upon the occurrence of a specified future event – e.g. the achievement of certain financial or operational thresholds.

Contingent consideration is included in the total consideration transferred to purchase the acquiree; therefore, it is recognized at acquisition date fair value. If contingent consideration is liability-classified, it is remeasured at each reporting date and changes to the liability are recognized in earnings.



Question 8.2.120

Are equity-linked contingent consideration arrangements in the scope of Subtopic 815-40?

Interpretive response: Yes, when they are not in the scope of Topic 718 or classified as a liability under Topic 480. The scope of Subtopic 815-40 includes contingent consideration arrangements that are indexed to (or otherwise based on) the price of the entity's stock.

However, many equity-linked contingent consideration arrangements do not meet Subtopic 815-40's conditions to be equity-classified and, as a result are classified as a liability and remeasured to fair value at each reporting date with changes in fair value recognized in earnings. Nevertheless, if as a result of the analysis, an arrangement meets the criteria to be equity-classified, it is not remeasured during the period it is outstanding, and its settlement is recorded in equity.

Chapter 6 of KPMG Handbook, [Business combinations](#), discusses the accounting for contingent consideration.

8.2.60 Guarantee contracts



Excerpt from ASC 815-40

> Other Considerations

- > Derivative Instruments and Embedded Derivatives

15-9 For guidance on the interaction of this Subtopic and Subtopic 815-10, see paragraphs 815-10-15-74 through 15-78. For guidance on the interaction of this Subtopic and Subtopic 815-15, see paragraph 815-15-25-15.

- > Guarantees

15-10 Topic 460 provides an exception from its initial recognition and initial measurement requirements, but not its disclosure provisions, for a guarantee for which the guarantor's obligation would be reported as an equity item (rather than a liability) under generally accepted accounting principles (GAAP).

15-11 If a contract under this Subtopic is required to be accounted for as a liability under this Subtopic and also meets the definition of a guarantee under Topic 460 (for example, a **physically settled** written put option), both this Subtopic and that Topic are consistent with respect to requiring the issuer to account for the contract at **fair value** at the initial measurement date. In that situation, the guarantee would also be subject to the disclosure requirements of Topic 460.

Among other types of instruments, Topic 460 (guarantees) applies to contracts that contingently require a guarantor to make payments to a guaranteed party based on changes in an underlying related to an asset, a liability or an equity security of the guaranteed party. These payments can be in the form of cash, financial instruments, other assets, shares of the guarantor's stock or provision of services. [\[460-10-15-4 – 15-5\]](#)

A guarantee contract indexed to, and potentially settled in, an entity's own stock might fall in the scope of both Subtopic 460-10 and Subtopic 815-40. How a guarantor's obligation is accounted for when the guarantee is in the scope of Topic 460 depends on how it is classified under other Topics.

Guarantee reported as equity under US GAAP (e.g. Subtopic 815-40)	Guarantor does not apply the recognition and initial measurement provisions in Topic 460, but does comply with Topic 460's disclosure requirements. [815-40-15-10, 460-10-25-1(d), 30-1, 50-1]
Guarantee accounted for as a liability under Subtopic 815-40	Guarantor applies the initial measurement provisions in Topic 460 (and Subtopic 815-40), which require the guarantee to be measured at fair value. Topic 460's disclosure requirements also apply. [815-40-15-11]

8.3 Unit of account



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

15-5B The guidance in paragraphs 815-40-15-5 through 15-8 shall be applied to the appropriate unit of accounting, as determined under other applicable U.S. generally accepted accounting principles. For example, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be accounted for separately, then the guidance in paragraphs 815-40-15-5 through 15-8 shall be applied separately to each instrument. In contrast, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be linked and accounted for on a combined basis as a single financial instrument (for example, pursuant to the guidance in paragraph 815-10-15-8), then the guidance in paragraphs 815-40-15-5 through 15-8 shall be applied to the combined financial instrument.

20 Glossary

Freestanding Contract

A freestanding contract is entered into either:

- Separate and apart from any of the entity's other financial instruments or equity transactions
- In conjunction with some other transaction and is legally detachable and separately exercisable.



Excerpt from ASC 815-10

•• > Viewing Two or More Contracts as a Unit in Applying the Scope of This Subtopic

15-9 If two or more separate transactions may have been entered into in an attempt to circumvent the provisions of this Subtopic, the following indicators shall be considered in the aggregate and, if present, shall cause the transactions to be viewed as a unit and not separately:

- a. The transactions were entered into contemporaneously and in contemplation of one another.
- b. The transactions were executed with the same counterparty (or structured through an intermediary).
- c. The transactions relate to the same risk.
- d. There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

A unit of account is defined as '[t]he level at which an asset or a liability is aggregated or disaggregated in a Topic for recognition purposes'. When analyzing an equity-linked financial instrument, it is important to identify the unit(s) of account because Subtopic 815-40 is applied to each unit of account separately. [815-40-15-5B, 820-10 Glossary]

An equity-linked financial instrument is considered an individual unit of account if it is a freestanding contract. This is the case when the instrument is entered into either: [815-40 Glossary]

- separate from any of the entity's other financial instruments or equity transactions; or
- in conjunction with another transaction but is legally detachable and separately exercisable.

Sometimes an entity will enter into two or more separate transactions that should be combined into a single unit of account. The following are indicators of when these separate transactions should be combined: [815-10-15-9]

- the transactions were entered into at the same time, and in contemplation of one another;
- the transactions were entered into with the same counterparty;
- the transaction relates to the same risk; and
- the economics of the separate transactions are the same as they would be if they had been combined into a single transaction.

Section 6.3 discusses how to determine the appropriate unit of account when analyzing an equity-linked financial instrument.



Question 8.3.10

What are the units of account if an equity-linked financial instrument is subject to a registration payment arrangement?



Excerpt from ASC 815-40

> Effect of a Registration Payment Arrangement

25-43 Subtopic 825-20 requires that an entity recognize and measure a registration payment arrangement (see paragraph 825-20-15-3) as a separate unit of account from the **financial instrument(s)** subject to that arrangement.

Accordingly, under that Subtopic (see paragraphs 825-20-25-2 and 825-20-30-2), a financial instrument that is both within the scope of this Subtopic and subject to a registration payment arrangement shall be recognized and measured in accordance with this Subtopic without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

Background: Sometimes an equity-linked financial instrument is issued together with a registration payment arrangement. A registration payment arrangement has both of the following characteristics: [\[815-40 Glossary\]](#)

- it requires the entity to endeavor (i.e. use its 'best efforts' or apply 'commercially reasonable efforts') to either:
 - file a registration statement for the resale of a specified financial instrument and/or the equity shares issuable upon exercise of the instrument, and for that registration statement to be declared effective; or
 - maintain an effective registration statement for a period of time (or in perpetuity);
- it requires the entity to transfer consideration to the holder of the financial instrument if the registration statement is not declared effective or does not remain effective.

The consideration to be transferred to the holder of the financial instrument is often calculated as a percentage of the proceeds from the issuance of the security. It may be in the form of cash, equity shares or as an adjustment to the terms of the instrument(s) that are subject to the registration payment arrangement – e.g. an increased interest rate on a debt instrument.

Interpretive response: If an equity-linked financial instrument being analyzed under Subtopic 815-40 is subject to a registration payment arrangement, the financial instrument and the registration payment arrangement are considered separate units of account. Effectively, the registration payment arrangement is disregarded in the analysis under Subtopic 815-40 and is accounted for under Subtopic 450-20 for the contingent obligation to make any future payments. [\[815-40-25-43\]](#)

8.4 Common equity-linked financial instruments

Some of the more common instruments in the scope of Subtopic 815-40 are discussed in this section. All of the descriptions included in this section are in the context of an equity-linked financial instrument involving the issuer of the underlying shares.

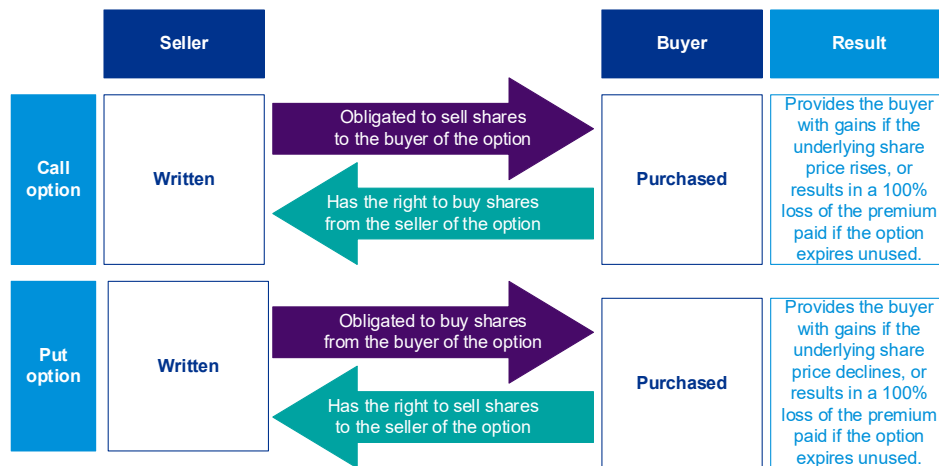
8.4.10 Options

Question 8.4.10 What is an option?

Interpretive response: An option on an underlying equity share is an equity-linked financial instrument that gives the holder the right to buy (call) or sell (put) shares of another party's stock at a specific price (the strike price), and obligates the issuer of the option to fulfill the transaction. There are two common types of options.

- A **put option** is a contract giving the holder the option to **sell** shares of the issuer's stock at a future date for a specified strike price.
- A **call option** is a contract giving the holder the option to **buy** shares of the issuer's stock at a future date for a specified strike price.

An option is referred to by the holder as **purchased** and by the issuer as **written**, as follows.



An option can be either freestanding or embedded in a host instrument.

A warrant is an example of a written call option. A warrant allows the holder to purchase the underlying stock of the issuer at a fixed price (subject to adjustment) for a specified period of time – e.g. a warrant that permits its holder to purchase 100 shares of the issuer's common stock for \$5 per share at any time during the warrant's 20-year term. Once the price per share of the issuer's common stock is in excess of \$5 per share, the holder is incentivized to exercise the warrants because they will be purchasing shares at a price that is below-market.



Question 8.4.20

Is a put warrant in the scope of Subtopic 815-40?

Interpretive response: Unlike a regular warrant, a put warrant gives the holder the option to put the warrant to the issuer – i.e. the holder can require the issuer to repurchase the warrant for cash or other assets. Such an instrument is outside of the scope of Subtopic 815-40 and is instead analyzed under Topic 480 because, as discussed in section 6.5, one of the three types of instruments in the scope of Topic 480 is an obligation to repurchase the issuer's equity shares by transferring assets.

8.4.20 Forward contracts



Question 8.4.30

What is a forward contract and is it in the scope of Subtopic 815-40?

Background: A forward contract is an agreement between two parties giving the buyer an obligation to purchase an asset and the seller an obligation to sell that asset for a set price at a future point in time.

A forward sale contract obligates the issuer to **sell** shares of its stock at a future date for a specified price. An example of a forward sale contract is a forward contract to sell 200 shares of the issuer's common stock for \$20 a share in one year from the contract's inception date.

Conversely, a forward **purchase** contract obligates the issuer to buy shares of its stock at a future date for a specified price. An example of a forward purchase contract is a contract whereby an issuer agrees to buy 100 shares of its own stock for \$50 a share on March 15, Year 2.

Interpretive response: A forward purchase contract is in the scope of Topic 480 (see Question 6.6.70) and therefore outside the scope of Subtopic 815-40. Similar to written call options (see Question 8.4.10), forward sale contracts are generally outside the scope of Topic 480, and therefore are generally in the scope of Subtopic 815-40.

8.4.30 Conversion features



Question 8.4.40

Is a conversion feature in the scope of Subtopic 815-40?

Interpretive response: The conversion feature of a convertible debt instrument is analyzed to determine whether it meets the own equity scope exception from derivative accounting if it:

- meets the definition of a derivative; and
- otherwise requires bifurcation under Subtopic 815-15 – before considering whether it qualifies for the own equity scope exception.

Convertible debt instruments come in many forms, which are discussed in chapter 10. As discussed in section 8.12, additional conditions in Subtopic 815-40 must be met for the conversion feature to qualify for equity classification. However, these additional conditions do not apply to certain convertible instruments where the holder can realize the value of the conversion option only by exercising the option and receiving the entire proceeds in either a fixed number of shares or the equivalent amount of cash at the option of the issuer (see section 8.16.10).

8.4.40 Accelerated share repurchase programs



Question 8.4.50

Are the elements of an ASR program in the scope of Subtopic 815-40?

Interpretive response: An ASR program is a combination of transactions that allows an entity to repurchase a targeted number of shares immediately, with the final repurchase price determined by an average market price over a fixed period of time. [505-30-25-5]

An entity generally accounts for an ASR as the following two separate transactions: [505-30-25-6]

- a repurchase of common shares in a treasury share transaction recorded on the acquisition date; and
- a net-settled forward sale contract.

For guidance on treasury stock repurchase transactions, see section 5.8.20.

If the forward contract portion of an ASR is not in the scope of Topic 480, it is analyzed to determine whether it is accounted for as an equity instrument or as an asset or liability, based on the guidance in Subtopic 815-40.

8.4.50 Call spreads

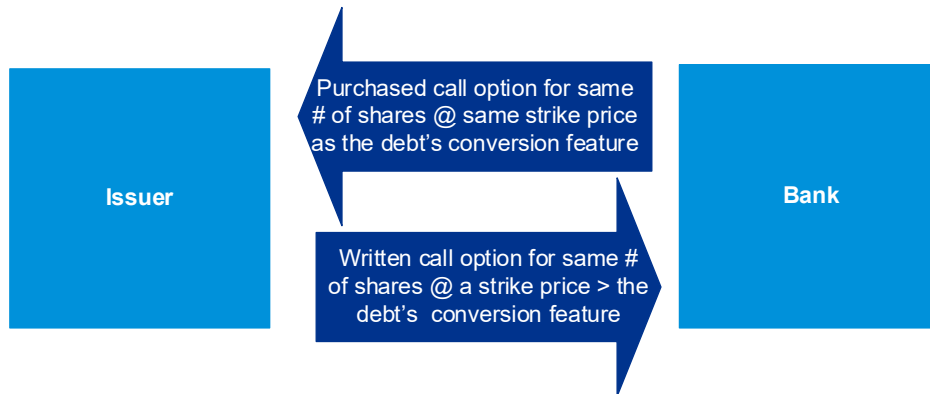
Sometimes an entity will enter into a call spread concurrent with issuing convertible debt.



Question 8.4.60

What are call spreads and how are they structured?

Interpretive response: A call spread involves two transactions.



Each time a conversion of the convertible debt is executed, the purchased call option is settled for the same number of shares that were issued on conversion. Because the purchased call option's strike price is the same as the conversion feature, the impact of the conversion is offset by settling the purchased call.

In a call spread transaction, the issuer is paying a premium by purchasing a call option from a bank and receiving a premium by issuing a written call option to the bank.

The objective of a call spread arrangement is to synthetically increase the strike price of the conversion feature within the convertible debt instrument. On conversion, the exercise of the purchased call option and the written call option will simultaneously:

- take the same number of shares as the conversion feature in the bond – at the same strike price – off the market (the purchased call option); and
- issue the same number of new shares at a strike price that is higher than the effective conversion price on the bond (the written call option).

Capped call transactions

A call spread can either be documented as two separate transactions (i.e. a purchased call option and a written call option) or it can be structured as a single transaction referred to as a capped call option.

Similar to the purchased call option in a scenario where there are two separate transactions, a capped call option has the same strike price as the debt's conversion feature. However, instead of a separate written call option with a

strike price that is greater than the conversion feature's strike price, the capped call option's settlement amount is 'capped' at the same amount that a separate written call option with a higher strike price would have been settled. This results in the same economics as if the issuer were to enter into two separate transactions.

Tax caps in capped call transactions

For a capped call and the related convertible debt to be treated as a single combined synthetic instrument for tax purposes, the terms of a capped call transaction may include a cap on the amount due to the issuer (e.g. lower of the capped call's fair value and the tax cap amount) if the capped call is settled early because the related debt is converted early. Such a provision is referred to as a 'tax cap'.

The mechanics of a tax cap can vary by instrument. For example, some instruments may define the tax cap amount as any excess of the amount paid to the convertible debt holder upon early conversion over the original issue price of the convertible debt.

Alternatively, a tax cap may be defined as any excess in the amount paid to the convertible debt holder upon early termination over an amount that varies solely as a function of time. For example, it may be defined as any excess of the amount paid to the convertible debt holder upon early conversion over what might be referred to as the 'tax accreted amount', which is generally calculated as the intrinsic value of the conversion option plus a portion of its option time value (or in another manner in which the only variable input is the date).

The structure of a tax cap in a capped call transaction can call into question whether an instrument meets the requirements of Step 2 of the indexation guidance (see Question 8.8.240).



Question 8.4.70

What are the units of account in a call spread?

Background: As discussed in section 8.3, the guidance in Subtopic 815-40 is applied to each unit of account separately. When a call spread transaction is entered into along with a convertible debt instrument, there are three instruments that need to be analyzed under Subtopic 815-40:

- the convertible debt instrument;
- the purchased call option; and
- the written call option.

An entity determines whether each of the instruments represents a separate unit of account, or whether to view a combination of any of them as a single unit of account, before applying the guidance of Subtopic 815-40.

Section 6.3 discusses determining the appropriate unit of account to use when analyzing an equity-linked financial instrument.

Interpretive response: While all facts and circumstances of the transaction need to be considered, we generally believe the convertible debt instrument

should be considered a separate unit of account from the call spread – i.e. the purchased call option and the written call option.

Among other things, separate transactions that are executed with the same counterparty can sometimes be an indicator that two or more contracts should be combined and viewed as one unit of account. In a call spread transaction entered into with the issuance of convertible debt, an investment bank is the counterparty to the purchased and written call options, whereas counterparties to the convertible debt are individual investors. Further, there is a substantive business purpose to executing the convertible debt and the call spread in two different transactions. The investors in a convertible debt seek a lower conversion price while the issuer of a convertible debt seeks a higher conversion price; the issuer's objective of a higher conversion price is accomplished through the call spread transaction.

Therefore, we generally believe the convertible debt and the call spread should be analyzed as two units of account.

The call spread – which comprises the purchased call option and the written call option – is entered into with an investment bank. Whether the two options are each freestanding instruments depends on whether they are legally detachable and separately exercisable. That may be the case if the two options are exercisable at different dates, for example:

- the purchased call option is exercisable when the conversion option in the convertible debt is exercised; and
- the written call option is exercisable for a period after the debt instrument matures.

However, even if they are considered freestanding instruments, the guidance in paragraph 815-10-15-9 should be analyzed to evaluate if the two options should be combined as one unit of account.

Applicability to capped call transactions

Similar to a typical call spread that is structured as two separate transactions, a capped call option must first be analyzed to determine the appropriate unit(s) of account. In general, we believe the convertible debt instrument should be considered a separate unit of account from the capped call, for the same reasons it is a separate unit of account in a typical call spread. However, we believe the capped call is generally a single contract – i.e. a net purchased call option with a cap on its settlement amount.

8.5 Analyzing contractual terms

To properly analyze an equity-linked financial instrument under Subtopic 815-40, it is important to understand all of the provisions in the agreement that could impact the settlement amount or how the instrument will be settled.

Contracts on an entity's own equity are frequently drafted using standard agreements developed by the International Swaps and Derivatives Association (ISDA). Standard ISDA agreements include the following.

- Master Agreement, which is an umbrella document that includes the general terms between the parties. Several future transactions may come under a single master agreement.
- Schedule to the Master Agreement, which amends and supplements the terms of the master agreement as required by the parties to the agreement.
- Equity Derivatives Definitions, which explains common contract terms and terminology.
- Confirmation.

Any number of transactions can be entered into under one Master Agreement. The Confirmation contains the economic terms of each individual trade and typically incorporates certain defined terms by reference to an ISDA definitions booklet. It is imperative to carefully consider both the Confirmation terms and Master Agreement provisions. [\[2007 AICPA Conf\]](#)



Example 8.5.10

Contract terms that can affect the analysis under Subtopic 815-40

Standard ISDA agreements generally include provisions that modify or terminate the agreement upon the occurrence of certain events, such as a merger, tender offer, bankruptcy or delisting, a hedging disruption or increase in the cost of hedging, or an increased stock borrow cost. Such provisions often result in adjustments to the settlement amount that can be problematic under the requirements of Step 2 of the indexation guidance (see section 8.8).

Further, some contracts may require an instrument to be cash-settled upon the occurrence of such events, which precludes an instrument being equity-classified (see section 8.10).

8.6 Overview of Subtopic 815-40

8.6.10 Overview

Analysis under Subtopic 815-40 determines whether:

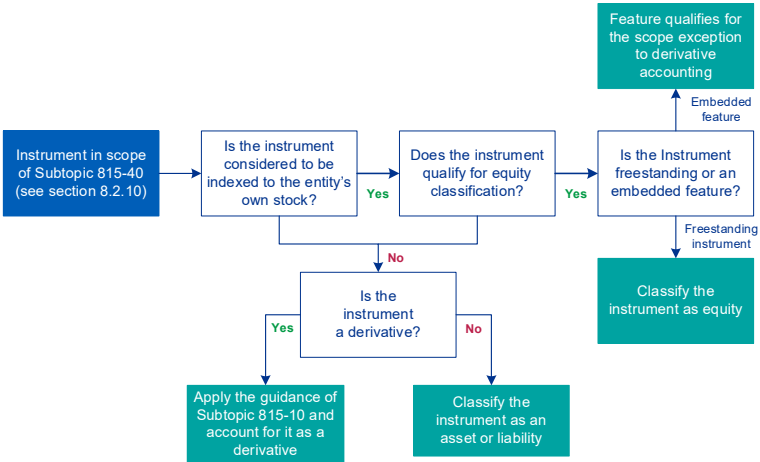
- an equity-linked financial instrument qualifies for the own equity scope exception from derivative accounting; and/or
- the instrument qualifies for equity classification.

The two key issues in the analysis of an instrument under Subtopic 815-40 are whether the instrument:

- is considered indexed to the entity's own stock – (the 'indexation guidance'); and
- qualifies for equity classification – (the 'equity classification guidance').

Question 8.6.10
What are the steps for analyzing an equity-linked financial instrument or feature under Subtopic 815-40?

Interpretive response: The two key issues in analyzing an instrument under Subtopic 815-40 – the indexation guidance and the equity classification guidance – and the additional steps in determining the appropriate accounting for an equity-linked financial instrument or feature are illustrated in the following decision tree.



Whether an instrument is considered to be indexed to the entity's own stock is discussed in section 8.6.20. Whether an instrument qualifies for equity classification is discussed in section 8.6.30.

8.6.20 The indexation guidance

Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

15-7 An entity shall evaluate whether an equity-linked financial instrument (or embedded feature), as discussed in paragraphs 815-40-15-5 through 15-8 is considered indexed to its own stock within the meaning of this Subtopic and paragraph 815-10-15-74(a) using the following two-step approach:

- Evaluate the instrument's contingent exercise provisions, if any.
- Evaluate the instrument's settlement provisions.

The indexation guidance determines whether an equity-linked financial instrument is indexed to an entity's own stock.

If the instrument meets the requirements of the indexation guidance, it is then analyzed under the equity classification guidance to determine whether it is classified as equity (see section 8.10). In contrast, if the instrument does not meet the requirements of the indexation guidance, no further analysis is necessary. In that case, if the financial instrument is an embedded feature that is a derivative or a freestanding derivative instrument, it is accounted for as a derivative. If it is a freestanding financial instrument that is not a derivative, it is classified as an asset or a liability. [815-40-15-8A]



Question 8.6.20 What is indexation?

Interpretive response: Indexation means that the value of an instrument or feature varies with changes in the value of its underlying. Generally, for an instrument to satisfy the requirements of the indexation guidance, it must be indexed only to the entity's own stock. A feature that is indexed to stock of the entity and another underlying (e.g. commodity prices) does not qualify as indexed to an entity's own stock.

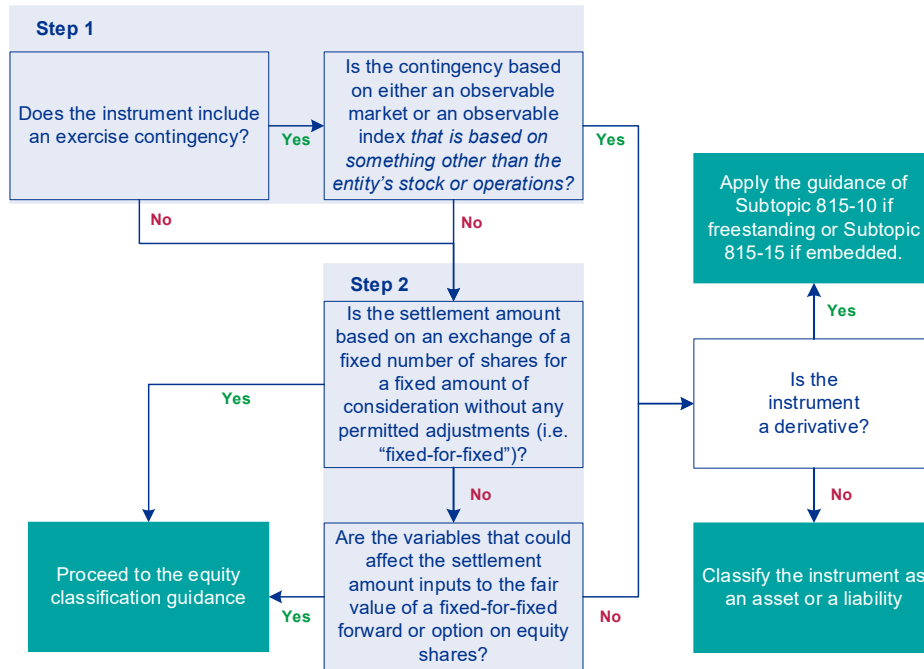


Question 8.6.30 How is the indexation guidance applied?

Interpretive response: The indexation guidance contains two steps. [815-40-15-7]

Step 1	Evaluate an instrument's exercise contingencies	— applies only to instruments that have a contingent exercise provision
Step 2	Evaluate an instrument's settlement provisions	— applies to instruments with a contingent exercise provision that meet the Step 1 requirements; and — applies to instruments without a contingent exercise provision

The following decision tree explains how to apply these steps.



For guidance on analyzing an equity-linked financial instrument under Step 1 and Step 2 of the indexation guidance, see sections 8.7 and 8.8, respectively; and see section 8.9 for an explanation of the interaction between Steps 1 and 2.

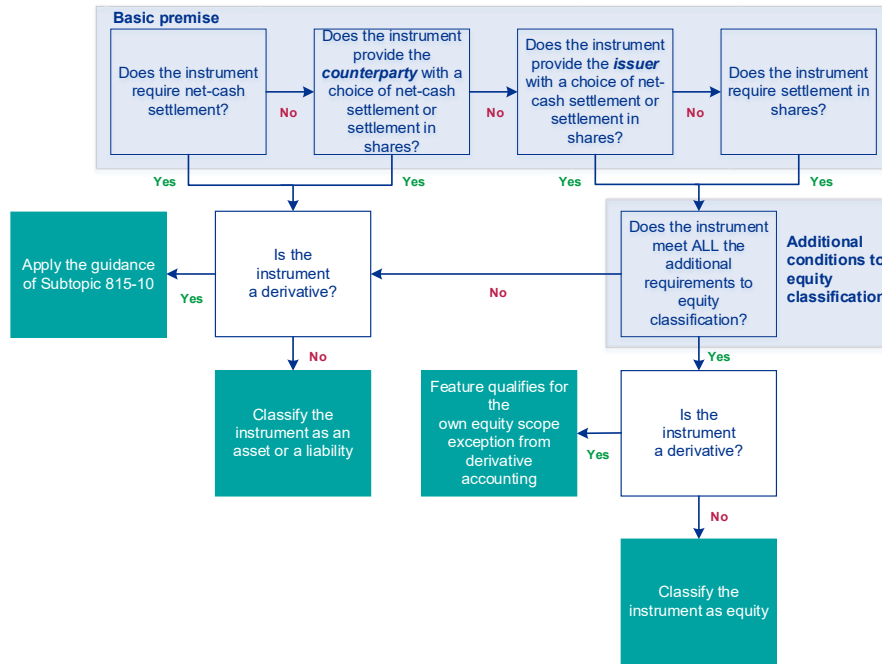
8.6.30 The equity classification guidance

The final analysis performed under Subtopic 815-40 determines whether a financial instrument qualifies for equity classification. A freestanding instrument that meets the requirements of the equity classification guidance (and the indexation guidance in 8.6.20) is classified as equity. If an embedded feature meets the requirements, it qualifies for the own equity scope exception from derivative accounting.

Question 8.6.40
How is the equity classification guidance applied?

Interpretive response: The equity classification guidance addresses how an equity-linked financial instrument that is indexed to the entity's own stock is settled. Generally, for such an instrument to be classified as equity, it needs to permit the entity to settle in shares. However, Subtopic 815-40 clarifies that certain conditions must exist before an entity can conclude it has the ability to settle in shares.

The following decision tree summarizes the steps involved to analyze an equity-linked financial instrument under the equity classification guidance.



Section 8.10 introduces the basic premise of equity classification and section 8.12 explains each of the additional conditions that an instrument must meet to qualify for equity classification. There are some situations in which cash settlement is permitted; these are discussed in section 8.11. Finally, section 8.13 explains the initial and subsequent accounting for financial instruments analyzed under Subtopic 815-40.

8.7 Step 1 of the indexation guidance – evaluating contingent exercise provisions



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

- > Evaluation of Contingent Exercise Provisions (Step 1)

15-7A An **exercise contingency** shall not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on either of the following:

- An observable market, other than the market for the issuer's stock (if applicable)

- b. An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer; earnings before interest, taxes, depreciation, and amortization of the issuer; net income of the issuer; or total equity of the issuer).

If the evaluation of Step 1 (this paragraph) does not preclude an instrument from being considered indexed to the entity's own stock, the analysis shall proceed to Step 2 (see paragraph 815-40-15-7C).

If an equity-linked financial instrument has a contingent exercise provision, it first has to be analyzed under Step 1 of the indexation guidance before it can be analyzed under Step 2. If it does not have a contingent exercise provision, Step 1 is skipped, and the instrument is analyzed under Step 2. [815-40-15-7A]



Question 8.7.10

What is a contingent exercise provision?

Interpretive response: A contingent exercise provision, or exercise contingency, is a provision that entitles the issuer (or the counterparty) to exercise an equity-linked financial instrument based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Examples of exercise contingencies include provisions that accelerate the timing of the issuer's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable.

A clause is not a contingent exercise provision if it does not affect whether the instrument is exercisable. If it only affects the settlement amount, it is analyzed under Step 2 (see section 8.8).



Question 8.7.20

What type of contingent exercise provisions are permitted under Step 1 of the indexation guidance?

Interpretive response: Contingent exercise provisions can take many forms. Provisions that are based directly on the entity achieving a metric or completing a specific event generally meet the requirements of Step 1 of the indexation guidance. However, if a provision is based on an observable market or index that is not based only on the entity's metrics (e.g. the S&P 500 index), the instrument or feature fails Step 1 of the indexation guidance and is not considered to be indexed to the entity's own stock. [815-40-15-7A]

Question 8.7.30
What are example contingent exercise provisions that would pass or fail Step 1 of the indexation guidance?

Interpretive response: While not an exhaustive list, the following table illustrates certain contingent exercise provisions and whether they would cause an equity-linked financial instrument to pass or fail Step 1 of the indexation guidance.

A contingent exercise provision...			
based on changes in the S&P 500 index	requiring certain performance of the crude oil futures market	dependent in the occurrence of an IPO	based on achievement of a revenue target for the entity
that is triggered when the share price of the entity is above the industry's stock market index	based on changes to the Federal Funds rate	based on growth of the fair value of a wholly owned consolidated subsidiary of the issuing entity that is a substantive entity	that is triggered upon the acquisition of the issuing entity by another entity
requiring the price of gold to drop below a specified level	that is triggered when the consumer price index exceeds a certain level	based on a specified reduction in expenses of the entity	that is triggered upon a change in control
... precludes an instrument from being considered indexed to an entity's own stock		... does NOT preclude an instrument from being considered indexed to an entity's own stock	

We believe an exercise contingency that is based on an index calculated solely by reference to the operations of a consolidated subsidiary is permitted under Step 1 of the indexation guidance, provided that the subsidiary is a substantive entity.

Example 8.7.10
Exercise contingency based on an observable index

Scenario 1: Index is entity-specific

Issuer issues warrants that permit Holder to purchase 100 shares of its common stock for \$5 per share. The warrants have a 20-year term, and become exercisable only once Issuer accumulates \$2 billion in sales.


The exercise contingency is the accumulation of \$2 billion in sales, which is based on an index calculated or measured solely by reference to Issuer's own operations. Therefore, because the index can only be calculated or measured by reference to Issuer's sales, the exercise contingency does not preclude the warrants from being considered indexed to the entity's own stock. As a result,

Issuer now analyzes the instrument under Step 2 of the indexation guidance, which evaluates the settlement amount (see section 8.8).

Scenario 2: Index is not entity-specific

Similar to Subtopic 815-40's Example 4 (below), the warrants become exercisable only if the S&P 500 Index increases 400 points within any given calendar year during the warrants' 20-year term.

The warrants are not considered indexed to the entity's own stock because the exercise contingency is based on an observable index that is not measured solely by reference to Issuer's own operations. Therefore, the warrants are not classified as equity under Subtopic 815-40.



Excerpt from ASC 815-40

- > Example 4: Variability Involving Stock Index

55-28 Entity A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms; however, they only become exercisable if the Standard & Poor's S&P 500 Index increases 500 points within any given calendar year during that 10-year period. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The exercise contingency (that is, the increase of 500 points in Standard & Poor's S&P 500 Index) is based on an observable index that is not measured solely by reference to the issuer's own operations.
- b. Step 2. It is not necessary to evaluate Step 2.

8.8 Step 2 of the indexation guidance – evaluating the settlement provisions

8.8.10 Overview

Once an entity determines that the contingent exercise provisions in an equity-linked financial instrument meet the requirements of Step 1 of the indexation guidance (or that Step 1 does not apply), it determines whether the settlement provisions meet the requirements of Step 2 of the indexation guidance.

Analyzing an instrument under Step 2 of the indexation guidance requires a thorough understanding of the settlement provisions of the instrument, and any potential adjustments to them. For purposes of this analysis, each and every potential adjustment must be analyzed regardless of the likelihood of the adjustment.

This section first introduces the concept of a fixed-for-fixed settlement provision, which is generally required for an equity-linked financial instrument to meet the requirements of Step 2 of the indexation guidance (see section 8.8.20).

This section then defines explicit inputs (see section 8.8.40) and implicit inputs (see section 8.8.50) that are used in the valuation of a fixed-for-fixed forward or option on equity shares, and explains some adjustments to these inputs that do not preclude an instrument from meeting the requirements of Step 2 of the indexation guidance.

Finally, section 8.8.60 provides other considerations to keep in mind when analyzing an instrument under Step 2 of the indexation guidance, including:

- analyzing down-round and standard antidilution provisions;
- considering terms that allow for the modification of an equity-linked financial instrument; and
- analyzing an instrument whose strike price is denominated in a foreign currency.

8.8.20 The concept of fixed-for-fixed



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

- > Evaluation of Settlement Provisions (Step 2)

15-7C Unless paragraph 815-40-15-7A precludes it, an instrument (or embedded feature) shall be considered indexed to an entity's own stock if its settlement amount will equal the difference between the following:

- a. The fair value of a fixed number of the entity's equity shares
- b. A fixed monetary amount or a fixed amount of a debt instrument issued by the entity.

For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity shall be considered indexed to the entity's own stock.

For an equity-linked financial instrument to meet the requirements of Step 2 of the indexation guidance, it generally is required to have a fixed-for-fixed settlement provision. This means that the settlement amount must equal the difference between the fair value of a fixed number of the entity's shares and a fixed amount. [815-40-15-7C]



Question 8.8.10

When is a settlement provision fixed-for-fixed?

Interpretive response: The fixed amount can be a monetary amount or a fixed amount of a debt instrument issued by the entity. Subtopic 815-40's Examples

2 and 3 (below) illustrate the concept of fixed-for-fixed where the fixed amount is a monetary amount.

Alternatively, a convertible debt instrument may be settled for the difference between the fair value of a fixed number of shares and a fixed amount of a debt instrument issued by the entity. For example, an entity may issue a \$1,000 convertible bond that permits the holder to convert the bond into 10 shares of the entity's common stock.

Further, the settlement terms need not always result in a gross physical exchange of a fixed number of shares for a fixed monetary amount (or a fixed amount of a debt instrument issued by the entity). A contract that results in net-share settlement – i.e. a variable number of shares equal to the settlement amount – would also meet the fixed-for-fixed settlement provision.



Excerpt from ASC 815-40

- > Example 2: Variability Involving Completion of an Initial Public Offering

55-26 Entity A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms; however, they only become exercisable if Entity A completes an initial public offering. The warrants are considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.
- Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$10 per share).

- > Example 3: Variability Involving Sales Volume

55-27 Entity A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms; however, they only become exercisable after Entity A accumulates \$100 million in sales to third parties. The warrants are considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The exercise contingency (that is, the accumulation of \$100 million in sales to third parties) is an observable index. However, it can only be calculated or measured by reference to Entity A's sales, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.
- Step 2. Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$10 per share).



Example 8.8.10 Fixed-for-fixed settlement provision

Issuer issues warrants on July 15, Year 1 that permit Holder to purchase 20 shares of its common stock for \$25 per share. The warrants have a 20-year term, but are exercisable at any time.

Application of indexation guidance

Step 1	Step 1 does not apply because the terms of the warrants include no contingent exercise provisions.
Step 2	<p>Issuer determines that the settlement provisions are fixed-for-fixed. This is because on exercise, the settlement amount will equal the difference between:</p> <ul style="list-style-type: none"> — the fair value of 20 shares – i.e. a fixed number of Issuer's shares; and — \$500 (20 shares × \$25 per share) – i.e. a fixed amount.

As a result, Issuer concludes that the warrants meet the requirements of the indexation guidance of Subtopic 815-40.

Assume instead that, similar to Example 5 of Subtopic 815-40 (below), the warrants permit the holder to purchase 20 shares of Issuer's common stock for an ounce of gold. The settlement provisions are not fixed-for-fixed. Although the settlement amount is calculated using a fixed number of Issuer's shares, the monetary amount is not fixed because of the variability in the price of gold. In addition, an adjustment to the settlement amount based on changes in the price of gold is not a permitted adjustment (see sections 8.8.40 and 8.8.50).



Excerpt from ASC 815-40

- > Example 5: Variability Involving a Commodity Price

55-29 Entity A issues warrants that permit the holder to buy 100 shares of its common stock in exchange for one ounce of gold. The warrants have 10-year terms; however, they only become exercisable if Entity A completes an initial public offering. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.
- b. Step 2. The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies based on the price of one ounce of gold. The price of gold is not an input to the fair value of a fixed-for-fixed option on equity shares.



Question 8.8.20

Is the probability of an adjustment to the settlement amount considered in applying Step 2 of the indexation guidance?



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

- > Evaluation of Settlement Provisions (Step 2)

15-7D An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) shall still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares (provided that paragraph 815-40-15-7A does not preclude such a conclusion).

Interpretive response: No. If the terms of an equity-linked financial instrument allow for any type of adjustment to the settlement amount, the probability of the adjustment occurring is irrelevant when evaluating the instrument under Step 2. Further, whether the entity controls such adjustments is also irrelevant under Step 2 of the analysis. [815-40-15-7C – 15-7D]

Subtopic 815-40's Example 10 (below) describes an instrument that is settleable for the difference between a fixed number of shares and a fixed price, unless the entity does not obtain regulatory approval for a drug compound by a specified time. Even if the entity has a history of obtaining regulatory approval, the likelihood that it will obtain the regulatory approval is not considered under the indexation guidance. As a result, this instrument is not considered indexed to the entity's own stock.

As discussed in Question 8.8.50, a provision that may result in a fixed settlement amount that is not based on the entity's share price precludes the instrument from being considered indexed to the entity's own stock.



Excerpt from ASC 815-40

- > Example 10: Variability Involving Regulatory Approval

55-35 Entity A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms and are

exercisable at any time. However, the terms of the warrants specify that if Entity A does not obtain regulatory approval of a particular drug compound within 5 years, the holder can surrender the warrants to Entity A for \$2 per warrant (setttable in shares). The contingently puttable warrants are not considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.
- b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$10 per share), unless regulatory approval of a particular drug compound is not obtained within 5 years. If that approval is not obtained within the allotted time period, the holder could elect to surrender the warrants to Entity A in exchange for \$2 per warrant. The contingent obligation to settle the warrants by transferring consideration with a fixed monetary value if regulatory approval of a particular drug compound is not obtained within a specified time period does not represent an input to the fair value of a fixed-for-fixed option on equity shares. A freestanding equity-linked instrument that provides for a fixed payoff upon the occurrence of a contingent event which is not based on the issuer's share price is not indexed to an entity's own stock.

8.8.30 Adjustments to the settlement amount

As discussed in section 8.5, contracts on an entity's own equity are frequently drafted using standard agreements developed by the ISDA. Such agreements often include provisions that adjust an instrument's strike price or number of shares issued on settlement upon the occurrence of certain events – e.g. merger, bankruptcy filing, delisting of the entity's shares.

Further, certain other events could trigger adjustments to the settlement amount depending on the terms of a specific contract – e.g. those that cause share price discontinuity, increased cost of borrowing the entity's shares, increased cost of hedging. The primary purpose of such adjustments to the settlement amount is to protect the counterparty's exposure to the risks arising from certain events.

Further, the ISDA agreements typically identify the calculation agent responsible for making certain determinations and calculations as appropriate, who is expected to exercise judgment in good faith and make the determinations and calculations in a commercially reasonable manner.



Question 8.8.30

Can an equity-linked financial instrument meet Step 2 of the indexation guidance if it contains a provision that adjusts the settlement amount?

Interpretive response: An equity-linked financial instrument that contains a provision that adjusts the settlement amount meets Step 2 of the indexation guidance only if the adjustments are permitted by Subtopic 815-40.

There are three broad categories of permitted adjustments under Subtopic 815-40 – adjustments:

- to explicit inputs used in the pricing of a fixed-for-fixed forward or option contract on equity shares (see section 8.8.40);
- based on implicit inputs or assumptions used in standard pricing models for equity-linked financial instruments (see section 8.8.50); or
- pursuant to a down-round feature (see section 8.8.60).

Careful analysis of all the provisions that lead to potential adjustments to the settlement amount should be performed to determine whether they are permissible under Step 2 of the indexation guidance.

If an adjustment is otherwise permitted under the indexation guidance, the adjustment must be commercially reasonable; otherwise, the instrument fails Step 2 of the indexation guidance. [815-40-15-7E]



Example 8.8.20

Possible adjustments to the settlement amount

Issuer issues warrants on July 15, Year 1 that permit Holder to purchase 20 shares of its common stock for \$25 per share. However, the strike price becomes \$35 per share if Issuer's revenue doubles from one fiscal year to another. Issuer's revenue has been materially consistent for the past five years, and there are no indications that this will change in the future.

The warrants have a 20-year term and are exercisable at any time.

Application of indexation guidance

Step 1	Although this example includes an additional provision that applies if Issuer's revenue doubles in a certain time period, this is not a contingent exercise provision that needs to be evaluated under Step 1. This is because the warrants are still exercisable at any time.
Step 2	The settlement amount of the warrants would change if Issuer's revenue doubled from one fiscal year to another. Because the variable that could affect the settlement amount (i.e. a change in revenue) is an adjustment to neither an explicit (see section 8.8.40) nor an implicit (see section 8.8.50) input, Issuer concludes that the settlement provisions of the warrants are not fixed-for-fixed. In performing this evaluation, the likelihood of Issuer's revenue doubling from one year to another is not considered.

As a result, Issuer concludes that the warrants are not indexed to its own stock.



Question 8.8.40

What is the meaning of 'commercially reasonable'?

Interpretive response: Subtopic 815-40 defines commercially reasonable as being “sufficiently objective from a legal perspective to prevent a counterparty from producing an unrealistic value...”.

A commercially reasonable adjustment to the settlement amount of an equity-linked financial instrument for a contingent event provides the holder of the instrument with economics similar to those it would have experienced if the event had not occurred. The adjustment ‘neutralizes’ the impact of that event.

To illustrate, many equity-linked financial instruments include a provision that adjusts the settlement amount if an event occurs that results in a share price discontinuity (e.g. a merger). As discussed in section 8.8.50, such an adjustment is permitted under Step 2 of the indexation guidance. However, for the provision to be permitted, the adjustment must exist only to neutralize the effects of the share price discontinuity. In other words, the adjustment must be ‘commercially reasonable’. Subtopic 815-40’s Example 6 (below) illustrates an instrument with such a provision.

We believe adjustments like the one described above are not required to perfectly neutralize the effect of the invalidation of an implicit assumption. Instead, for such an adjustment to be permitted, its purpose must be to at least partially neutralize such effect. However, we believe an adjustment is prohibited under the indexation guidance if it would more than 100% offset any gain or loss that occurs because of an event that invalidates an implicit assumption. This is because any exposure in excess of the 100% offset would be inconsistent with the inputs to a fixed-for-fixed contract.



Excerpt from ASC 815-40

- > Example 6: Variability Involving Merger Announcement

55-30 Entity A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if there is an announcement of a merger involving Entity A, the strike price of the warrants will be adjusted to offset the effect of the merger announcement on the net change in the fair value of the warrants and of an offsetting hedge position in the underlying shares. The strike price adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered into a hedge position in the underlying shares to offset the share price exposure from the warrants. That strike price adjustment is not affected by the counterparty's actual hedging position (for example, the strike price adjustment does not differ in circumstances when the counterparty is over-hedged or under-hedged). The warrants are considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.
- b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$10 per share), unless there is a merger announcement. If there is a merger announcement, the settlement amount would be adjusted to offset the effect of the merger announcement on the fair value of the warrants. In that circumstance, the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed option on equity shares. For further discussion, see paragraphs 815-40-15-7E and 815-40-15-7G.



Question 8.8.50

What are the considerations in evaluating whether adjustments to the settlement amount are acceptable?

Interpretive response: An adjustment to the settlement amount may be based on an explicit input, or based on a triggering event that invalidates an implicit assumption, used in determining the fair value of a fixed-for-fixed forward or option contract. See sections 8.8.40 and 8.8.50 respectively for further discussion on adjustments to the settlement amount based on explicit inputs and implicit inputs.

For an adjustment to the settlement amount to meet Step 2 of the indexation guidance, the following general principles must apply. [815-40-15-7D – 15-7G]

- If the adjustment is based on an explicit input, it must be an explicit input used in determining the fair value of a fixed-for-fixed option or forward contract on equity shares (see section 8.8.40).
- If the adjustment is not based on an explicit input, it should be triggered by an event that invalidates an implicit assumption used in determining the fair value of a fixed-for-fixed option or forward contract on equity shares (see section 8.8.50).
- A change in an explicit input cannot affect the settlement amount in a manner inconsistent with how it would affect the fair value of a fixed-for-fixed option or forward contract on equity shares. In this context, the following are adjustments that do not meet this requirement (see section 8.8.60):
 - the settlement amount is inversely affected by changes to the input; or
 - the settlement amount is adjusted by an underlying input that is leveraged.
- An adjustment arising from an event that invalidates an implicit input must be consistent with the effect such an event had on the fair value of the instrument. This means that the adjustment either partially or fully offsets the change in fair value of the instrument under this circumstance.

However, the absence of an adjustment to the settlement terms arising from the occurrence of a specified event does not preclude an instrument from being considered indexed to an entity's own stock. For example, an instrument will not fail Step 2 of the indexation guidance if the contract does not include a provision that adjusts the settlement amount upon the entity announcing a merger.

- Any change in an explicit input or an implicit input cannot result in the settlement of the instrument at a fixed monetary amount.

Regardless of whether the adjustments are based on explicit inputs or implicit inputs, the adjustment must be commercially reasonable; otherwise, the instrument fails Step 2 of the indexation guidance.

Further, Question 8.8.150 discusses changes to the settlement amount based on a down-round provision.

8.8.40 Evaluating adjustments to the settlement amount based on explicit inputs



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

- > Evaluation of Settlement Provisions (Step 2)

15-7E A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including all of the following:

- a. Strike price of the instrument
- b. Term of the instrument
- c. Expected dividends or other dilutive activities
- d. Stock borrow cost
- e. Interest rates
- f. Stock price volatility
- g. The entity's credit spread
- h. The ability to maintain a standard hedge position in the underlying shares.

Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) shall be commercially reasonable.

15-7F An instrument (or embedded feature) shall not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. An instrument (or embedded feature) shall not be considered indexed to the entity's own stock if either:

- a. The instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares.
- b. The instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed in the preceding paragraph in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares.

An *explicit input* to the fair value of a fixed-for-fixed contract is an underlying (other than the occurrence or nonoccurrence of a specific event) that could adjust the settlement amount of the instrument.

Often, the terms of an equity-linked financial instrument include settlement provisions that adjust the settlement amount based on explicit inputs. These can include but are not limited to:

- financial metrics – e.g. share price, revenue, EBITDA;
- operational metrics – e.g. number of customers; and
- economic or industry metrics – e.g. a change to an index for the entity's industry, or a change in a commodity price.

If an instrument's terms allow for adjustments to the settlement amount, the instrument is not precluded from being considered indexed to the entity's own stock, as long as the variables that could adjust the settlement amount are inputs that are used in determining the fair value of a fixed-for-fixed forward or option contract.

As discussed in Question 8.8.20, if the terms of an equity-linked financial instrument allow for any type of adjustment to the settlement amount, the probability of the adjustment occurring is irrelevant when evaluating the instrument under Step 2. Further, as discussed in Question 8.8.40, any such adjustments must be commercially reasonable. [815-40-15-7C – 15-7F]



Question 8.8.60

Can an equity-linked financial instrument meet Step 2 of the indexation guidance if it contains a provision that adjusts the settlement amount?

Interpretive response: If the variables that could adjust the settlement amount are *not* inputs that are used in determining the fair value of a fixed-for-fixed contract, the instrument is precluded from being considered indexed to the entity's own stock.

One example of such a variable is the amount of an entity's annual revenues, which is illustrated in Subtopic 815-40's Example 7 (below). Another example is stock option exercise behavior, which is illustrated in Subtopic 815-40's Example 21 (below).



Excerpt from ASC 815-40

- > Example 7: Variability Involving Revenue Target

55-31 Entity A issues warrants that permit the holder to buy 100 shares of its common stock for an initial price of \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that the strike price is reduced by \$0.50 after any year in which Entity A does not achieve revenues of at least \$100 million. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.
- Step 2. The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price would be adjusted after any year in which Entity A does not achieve revenues of at least \$100 million. The amount of an entity's annual revenues is not an input to the fair value of a fixed-for-fixed option on equity shares.

- > Example 21: Variability Involving Securities Issued to Establish a Market-Based Measure of Grantee Stock Option Value

55-48 Entity A issues a security to investors for purposes of establishing a market-based measure of the grant-date fair value of a grant of stock options issued in a share-based payment transaction. Under the terms of that market-based stock option valuation instrument, Entity A is obligated to make variable quarterly payments to the investors that are a function of the net intrinsic value received by a pool of Entity A's grantees, based on actual stock option exercises by those grantees each period. The market-based stock option valuation instrument has a 10-year term, consistent with the contractual term of the underlying stock options. The market-based stock option valuation instrument is not considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The analysis of the exercise contingency (or contingencies) depends on the particular terms and features of the instrument. However, as indicated in Step 2 below, a market-based stock option valuation instrument would not be considered indexed to the entity's own stock.
- Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The instrument provides for variable quarterly payments to investors that are based on actual stock option exercises for the period. Because a variable that affects the instrument's settlement amount is stock option exercise behavior, which is not an input to the fair value of a fixed-for-fixed option or forward contract on equity shares, the instrument is not considered indexed to the entity's own stock.



Question 8.8.70

What are the inputs that are used in determining the fair value of a fixed-for-fixed forward or option contract?

Interpretive response: Inputs that are used in determining the fair value of a fixed-for-fixed forward or option contract typically include the following in addition to the entity's share price: [815-40-15-7C, 15-7E]

- strike price and term of the instrument
- expected dividends or other dilutive activities
- cost to borrow the stock
- interest rates
- stock price volatility
- entity's credit spread
- the ability to maintain a standard hedge position in the underlying shares.

Subtopic 815-40's Example 12 (below) illustrates an instrument whose strike price could be adjusted as a result of changes to the entity's historical dividend distributions, and to offset the effect of an increase in the cost to borrow the entity's stock. Because expected dividends and cost to borrow the entity's stock are both inputs used in determining the fair value of a fixed-for-fixed contract, this instrument is considered indexed to the entity's own stock.

Similarly, Subtopic 815-40's Examples 8, 15 and 16 (all below) illustrate instruments whose strike prices could be adjusted as a result of changes to the entity's share price, which is also an input used in determining the fair value of a fixed-for-fixed contract. Therefore, these instruments are also considered indexed to the entity's own stock.

Finally, the strike price of the instrument in Subtopic 815-40's Example 13 can be adjusted based on the 30-day volume weighted-average price (VWAP) of the entity's share price and an interest rate index. Both of these are inputs used in determining the fair value of a fixed-for-fixed contract, and therefore the instrument is considered indexed to the entity's own stock.



Excerpt from ASC 815-40

- > Example 8: Variability Involving Stock Price Cap

55-32 Entity A purchases net-settled call options that permit it to buy 100 shares of its common stock for \$10 per share. However, the maximum appreciation on the call options is capped when Entity A's stock price reaches \$15 per share (that is, the counterparty's maximum obligation is \$500 [($\$15 - \10) \times 100 shares]). The call options have 10-year terms and are exercisable at any time. The call options are considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price when Entity A's stock price is between the \$10 stated exercise price and the \$15 price cap. However, whenever Entity A's stock price exceeds \$15, the strike price of the call options increases and decreases in amounts equal to the corresponding increases and decreases in Entity A's stock price, such that the intrinsic value of each call option always equals \$5. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed option contract, the call options are considered indexed to the entity's own stock.

• > Example 12: Variability Involving Dividend Distributions

55-37 Entity A enters into a forward contract to sell 100 shares of its common stock for \$10 per share in 1 year. Historically, Entity A has paid a dividend of \$0.10 per quarter on its common shares. Under the terms of the forward contract, if dividends per common share differ from \$0.10 during any 3-month period, the strike price of the forward contract will be adjusted to offset the effect of the dividend differential (actual dividend versus \$0.10) on the fair value of the instrument. Additionally, the terms of the forward contract provide for an adjustment to the strike price, using commercially reasonable means, to offset the effect of any increased cost of borrowing Entity A's shares in the stock loan market on the fair value of the instrument. The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.
- b. Step 2. The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and \$1,000 (\$10 per share) are if dividends per common share differ from \$0.10 during any 3-month period or if there is an increased cost of borrowing Entity A's shares in the stock loan market. The adjustments to the strike price resulting from those events are intended to offset their effects on the instrument's fair value. In those circumstances, the only variables that could affect the settlement amount (dividends and stock borrow cost) would be inputs to the fair value of a fixed-for-fixed forward contract on equity shares.

• > Example 13: Variability Involving Average Stock Price

55-38 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A enters into a net-settleable forward contract to sell 100 shares of its common stock in 1 year for an amount equal to \$10 per share plus interest calculated at a variable interest rate (Federal Funds rate plus a fixed spread). The share price used to determine the settlement amount is based on the volume-weighted average daily market price of Entity A's common stock for the 30-day period before the settlement date. The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.
- b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a

fixed strike price. However, the only variables that cause the settlement amount to differ from a fixed-for-fixed settlement amount are the 30-day volume-weighted average daily market price of Entity A's common stock and an interest rate index. The pricing inputs of a fixed-for-fixed forward contract include the entity's stock price and interest rates. Additionally, the floating interest rate feature does not introduce a leverage factor or otherwise increase the effects of interest rate changes on the instrument's fair value.

- > Example 15: Variability Involving Stock Price Cap and Floor

55-40 Entity A enters into a net-settled forward contract to sell 100 shares of its common stock in 1 year for \$1,000. However, the maximum amount payable to the counterparty at maturity is capped when Entity A's stock price is greater than or equal to \$15 per share (that is, Entity A's maximum obligation is \$500 [$(\$15 - \$10) \times 100$ shares]). Additionally, the maximum amount receivable from the counterparty at maturity is capped when Entity A's stock price is less than or equal to \$5 per share (that is, the counterparty's maximum obligation is \$500 [$(\$5 - \$10) \times 100$ shares]). The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.
- Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$1,000) when Entity A's stock price is between \$5 and \$15. However, whenever Entity A's stock price is greater than or equal to \$15 at maturity, the amount payable to the counterparty always equals \$500. Additionally, whenever Entity A's stock price is less than or equal to \$5 at maturity, the amount receivable from the counterparty always equals \$500. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed forward contract, the instrument is considered indexed to the entity's own stock.

- > Example 16: Variability Involving Cap on Shares Issued

55-41 Entity A enters into a forward contract to sell a variable number of its common shares in 1 year for \$1,000. If Entity A's stock price is equal to or less than \$10 at maturity, Entity A will issue 100 shares of its common stock to the counterparty. If Entity A's stock price is greater than \$10 but equal to or less than \$12 at maturity, Entity A will issue a variable number of its common shares worth \$1,000. Finally, if the share price is greater than \$12 at maturity, Entity A will issue 83.33 shares of its common stock. The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.
- Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price (\$1,000). Although the strike price to be received at settlement is fixed, the number of shares to be issued to the counterparty varies based on the entity's stock price on the settlement date. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed forward contract on

equity shares, the instrument is considered indexed to the entity's own stock.

 **Example 8.8.30**
Adjustments to the settlement amount based on an entity's share price

Issuer issues warrants on July 15, Year 1 with the following settlement provisions.

Issuer's share price	Strike price of warrants
\$20 or below	\$18 per share
\$20 - \$22	\$19 per share
\$22 - \$25	\$20 per share
\$26 or above	\$24 per share

The warrants have a 20-year term, and are exercisable at any time.

Application of indexation guidance

Step 1	<p>A sliding scale is included in the provisions of these warrants, such that the warrants are always exercisable, but the exercise price depends on Issuer's share price.</p> <p>In this example, there is no contingent exercise provision that needs to be evaluated under Step 1, because the warrants are <i>always</i> exercisable. However, because the provision affects the settlement amount of the warrants (i.e. the price changes as Issuer's share price changes), it must be evaluated under Step 2.</p>
Step 2	<p>The settlement amount of the warrants changes as Issuer's share price changes. However, because the variable that could affect the settlement amount (i.e. Issuer's share price) would be an input in determining the fair value of a fixed-for-fixed instrument, Issuer concludes that the adjustment to the settlement amount of the warrants does not violate the fixed-for-fixed requirement.</p>

As a result, Issuer concludes that the warrants are indexed to its own stock, and proceeds to analyze the warrants under the equity classification guidance.

Note: If the sliding scale were instead based on changes to the S&P 500 index or to Issuer's EBITDA, the settlement provisions of the warrants would *not* be considered fixed-for-fixed. This is because the variable that could affect the settlement amount (i.e. changes to the S&P 500 index or to Issuer's EBITDA) is not an input in determining the fair value of a fixed-for-fixed instrument.



Question 8.8.75

Do settlement amount adjustments based on the price of a change-in-control transaction preclude equity-linked instruments from being considered indexed to the entity's own stock?

Background: Some equity-linked instruments (e.g. earnout arrangement issued in connection with a merger agreement) require settlement in a number of shares that varies based on the entity's share price at settlement. However, if there is a change in control of the entity, the price of the change-in-control transaction will be used (instead of the entity's share price) to determine the number of shares to be issued.

Interpretive response: It depends on whether the adjustment resulting from the price in the change-in-control transaction will be based on the fair value (or an approximation) of the entity's share price after giving effect to dilution arising from the change-in-control transaction.

For example, the change-in-control price per share could represent the fair value of the combined entity's share price if it is determined by dividing the total consideration by the fully diluted shares, including the shares issuable under the earnout arrangement, share based payment arrangement and other equity instruments (classified in equity or as an asset or liability).

In contrast, if the change-in-control price per share is determined by dividing the total consideration by the number of outstanding shares without giving effect to the dilution arising from the change-in-control transaction, that price may not represent the fair value of the combined entity's share price.

Change in control price represents fair value of the entity's share price

If the change-in-control price per share represents the fair value (or an approximation) of the entity's share price, we believe two interpretations are acceptable as an accounting policy election consistently applied.

- **The instrument *is* precluded from being considered indexed.** Although the adjustments to the settlement amount are based on the entity's share price at settlement, the settlement amount is also adjusted upon a change in control event, which is not an input to the fair value of a fixed-for-fixed forward or option on equity shares. Therefore, the instrument is not considered indexed to the entity's own stock and is classified as a liability.
- **The instrument is *not* precluded from being considered indexed.** Based on our informal discussions with the SEC staff, we believe it is acceptable to consider whether the price per share of the change-in-control transaction was based on the fair value (or an approximation).
 - If so, the adjustment would not preclude the instrument from being considered indexed to the entity's own stock under Step 2 because the fair value of the issuer's stock price is an acceptable input into a fixed-for-fixed option or forward pricing model on the issuer's stock price (see section 8.8.40).
 - However, if how the change in control price is determined is not specified for each potential change-in-control transaction (as defined in

the agreements), it is unlikely the instrument would be considered indexed to the entity's own stock, and therefore would be classified as a liability.

Change-in-control price does not represent fair value of the entity's share price

If the adjustment resulting from the price in the change-in-control transaction is not based on the fair value (or an approximation) of the entity's share price after giving effect to dilution arising from the change-in-control transaction, the earnout arrangement is not considered indexed to the entity's own stock and is classified as a liability.



Example 8.8.35

SPAC earnout arrangement classification

SPAC enters into a merger agreement to acquire Target for cash consideration. The merger agreement requires SPAC to issue shares of the post-combination successor entity's common stock to Target's former shareholders depending on whether certain contingent events occur.

The earnout arrangement is considered to be freestanding and is not in the scope of Topic 718 or 480 – i.e. it is in the scope of Subtopic 815-40 (see Question 8.2.120).

Scenario 1: Up to 3 million shares issuable depending on the combined entity's VWAP

Based on a volume-weighted average price of the combined company's shares over 20 out of 30 trading days (20-day VWAP) within three years following the merger date, up to a total of 3 million shares will be issued if the following thresholds are met.

20-day VWAP exceeds	Number of shares issuable ¹
\$10 per share	1 million
\$20 per share	Additional 1 million (i.e. total 2 million)
\$30 per share	Additional 1 million (i.e. total 3 million)
Note: 1. If the VWAP thresholds are not met within three years after the merger date, Target's former shareholders are not entitled to any shares for which the 20-day VWAP threshold was not met.	

The indexation guidance is applied to this arrangement as follows.

Step 1

Shares are only issuable upon achieving a specified 20-day VWAP, which is based on the market for the issuer's stock, and therefore the exercise contingency does not preclude the earnout arrangement from being considered indexed to the entity's own stock.

As a result, SPAC now analyzes the instrument under Step 2 of the indexation guidance.

Step 2	The settlement amount of the earnout arrangement changes as the entity's 20-day VWAP changes. However, because the variable that could affect the settlement amount (i.e. the entity's share price) would be an input in determining the fair value of a fixed-for-fixed instrument, SPAC concludes that the adjustment to the settlement amount does not preclude equity classification, consistent with Example 13 of Subtopic 815-40.
Note: The earnout is assumed to be one unit of account in this example. Question 8.9.10 discusses the unit of account.	

As a result, SPAC concludes that the earnout arrangement is indexed to its own stock, and proceeds to analyze it under the equity classification guidance.

Scenario 2: A fixed 3 million shares are issuable if the stock price exceeds a threshold or upon a change in control

Three million shares will be issued to Target's former shareholders if:

- the combined company's quoted stock price at any time during the three years after the merger exceeds \$30 per share; or
- a change in control of the post-combination successor entity occurs during the three years after the merger.

The indexation guidance is applied to this arrangement as follows.

Step 1	A fixed 3 million shares are issuable if either the stock price threshold is met or a change in control occurs, but no shares are issuable if neither of the triggers is met. Therefore, both the stock price trigger and the change in control trigger are exercise contingencies. Neither of these events causes the entity to fail Step 1 of the indexation guidance (see Question 8.7.30). As a result, SPAC now analyzes the instrument under Step 2 of the indexation guidance.
Step 2	The settlement amount of the earnout arrangement is a fixed number of shares (i.e. 3 million shares) and there is no adjustment to the settlement amount. Therefore, SPAC does not fail Step 2 of the indexation guidance.

As a result, SPAC concludes that the earnout arrangement is indexed to its own stock, and proceeds to analyze it under the equity classification guidance.

Scenario 3: Up to 3 million shares are issuable depending on the combined entity's VWAP or upon a change in control

Up to a total of 3 million shares will be issued based on the VWAP thresholds included in Scenario 1. However, if a change in control occurs at any price, all 3 million shares will be issued.

Step 1	Shares are issuable if either the stock price threshold is met or a change in control occurs, which are exercise contingencies. Neither exercise contingency precludes the earnout arrangement from being considered indexed to the entity's own stock. As a result, SPAC analyzes the instrument under Step 2 of the indexation guidance.
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Step 2	<p>The adjustments to the settlement amount in the case of varying VWAP levels are based on the entity's share price at settlement, which is a permitted adjustment (as explained in Scenario 1). However, the settlement amount also differs depending on whether a change in control occurs, which is not an input to the fair value of a fixed-for-fixed forward or option on equity shares.</p> <p>Therefore, SPAC determines that the settlement provisions do not meet the fixed-for-fixed requirement.</p>
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The earnout arrangement contains a settlement provision that causes the arrangement to fail Step 2 of the indexation guidance. Therefore, it is classified as a liability.

As discussed in section 8.14, the earnout arrangement is reassessed each reporting period to determine whether its classification continues to be appropriate. If SPAC's 20-day VWAP has exceeded \$20 per share, the earnout arrangement's remaining terms when reassessed will correspond with the terms in Scenario 2. Therefore, at that time, the earnout arrangement would be indexed to its own stock, and SPAC would proceed to analyze it under the equity classification guidance.

Scenario 4: Up to 3 million shares are issuable depending on the combined entity's VWAP or a change in control price trigger

Up to a total of 3 million shares will be issued based on the VWAP thresholds included in Scenario 1. However, if there is a change in control of the combined entity during the three years after the merger, the price of the change-in-control transaction will be used to determine whether the VWAP thresholds were met, and if so the number of shares corresponding to the VWAP threshold will be issued.

For example, if the change in control transaction takes place at \$20 per share, 2 million shares would be issued to Target's former shareholders using the earnout schedule in Scenario 1.

Step 1	<p>As discussed in Scenario 3, neither exercise contingency (i.e. achieving a specified 20-day VWAP or a change in control) precludes the earnout arrangement from being considered indexed to the entity's own stock.</p> <p>As a result, SPAC now analyzes the instrument under Step 2 of the indexation guidance.</p>
Step 2	<p>SPAC has an accounting policy to consider an adjustment based on a change in control price to not preclude the earnout arrangement from being considered indexed to the entity's own stock if that price represents the fair value (or an approximation) of the entity's share price after giving effect to the merger (as discussed in Question 8.8.75).</p> <p>SPAC concludes that the change-in-control price represents the fair value of the combined entity's share price because the arrangement clearly indicates that:</p> <ul style="list-style-type: none"> — if there is a full cash offer for the entire Company, the price per share will be determined on a fully diluted basis by dividing the total consideration by the total number of shares, including currently outstanding and all the shares issuable under the earnout

- arrangement, share-based payment arrangements and other equity instruments (whether equity- or liability-classified); and
- for all other change-in-control transactions described in the agreement, the change-in-control price will be determined based on the publicly traded price of the share the day immediately before the change in control event taking place. Therefore, the earnout arrangement is not precluded from being considered indexed to the entity's own stock.

As a result, SPAC concludes that the earnout arrangement is indexed to its own stock, and proceeds to analyze it under the equity classification guidance.



Question 8.8.80

Can adjustments to strike price that are based on changes in the CPI be considered fair value inputs of a fixed-for-fixed forward or option?

Interpretive response: It depends.

We believe the listing of potential fair value inputs in Subtopic 815-40 (see Question 8.8.70) is intended to be all-inclusive. However, we believe there are limited circumstances when adjusting a component of one of the above fair value inputs may be acceptable under Step 2 of the indexation guidance, as long as the adjustment is commercially reasonable (see Question 8.8.40).

When evaluating a term that provides for an adjustment to either the instrument's strike price or number of shares used to calculate the settlement amount, an entity determines whether the particular term is commercially reasonable and customarily included as a fair value input for a fixed-for-fixed contract in the entity's jurisdiction.

For example, an entity based in Country X issues warrants. The terms of the warrants specify that the strike price is adjusted for inflation based on changes in the CPI. When valuing a fixed-for-fixed forward or option on equity shares in Country X, cash flows are customarily discounted using an interest rate tied to CPI in lieu of market interest rates. This does not preclude the warrants from being considered indexed to the entity's own stock.

However, if the entity instead were based in the United States, the interest rate used in the valuation model generally would comprise a real interest rate (which is meant to measure the time value of money) and an inflation premium (which is meant to compensate for the expected loss in real value of money over time and is generally tied to an index like CPI). Therefore, an additional adjustment for inflation based on changes in CPI would effectively adjust for inflation twice and introduce leverage, which is inconsistent with the fair value inputs to the valuation of a fixed-for-fixed forward or option on equity shares. Such a provision is prohibited under the equity classification guidance. The warrants would not be considered indexed to the entity's own stock.



Question 8.8.90

Can an option on an entity's own equity be considered indexed to the entity's own stock if the payoff amount is determined based on fair value?

Background: A fixed-for-fixed settlement amount is the difference between:
[815-40-15-7C]

- the fair value of a fixed number of the entity's equity shares; and
- a fixed monetary amount (or a fixed amount of the entity's debt instrument).

In the case of an option – e.g. a warrant issued by an entity that gives the holder the right to buy 1,000 of the entity's equity shares at a strike price of \$10 per share – the settlement amount represents the intrinsic value of the option. To illustrate, assume that the current fair value of the entity's shares is \$16 per share. When the warrant is exercised, the fixed-for-fixed settlement amount contemplated in paragraph 815-40-15-7C is \$6,000 ($\$1,000 \times (\$16 - \$10)$), which is the warrant's intrinsic value.

Interpretive response: Yes. Sometimes the terms of an instrument will require the settlement amount to be calculated as the option's fair value on the date of exercise. Agreements with terms like this will often explicitly state that the instrument must be settled at its Black-Scholes fair value (or another pricing model).

As discussed above, if an instrument's terms allow for adjustments to the settlement amount, the instrument is not precluded from being considered indexed to the entity's own stock, as long as the variables that could adjust the settlement amount are inputs that are used in the pricing of a fixed-for-fixed contract.

We believe that contracts that require settlement at fair value are not precluded from being considered indexed to the entity's own stock if the option's fair value is determined using a pricing model (e.g. the Black-Scholes model) that uses the fair value inputs specified in paragraph 815-40-15-7E (listed in Question 8.8.70).



Question 8.8.100

Is an option precluded from being considered indexed to the entity's own stock if the settlement amount is calculated using a fixed, predetermined or flat volatility?

Background: Some equity-linked financial instruments include provisions that require the settlement amount to be calculated using a predetermined volatility input. Provisions such as these are often triggered when the contract is early terminated because of a change in control. The provision may require the settlement amount to be calculated using a volatility specified at inception of the instrument, or the greater of the market volatility at the time of settlement and a volatility specified at inception of the instrument.

In other cases, an issuer of convertible debt may enter into a capped call option strategy on its own shares. A capped call option is a purchased call option with a strike price matching the conversion price on the convertible debt issued, but the payoff is capped at an amount equal to the payoff of a similar but with higher strike price call option. The capped call option may be early terminated in certain circumstances such as when the entity repurchases the convertible debt, or when there is a fundamental change transaction (e.g. a merger). In some capped call options, the settlement amount for both the purchased call option and the cap amount in the event of early termination is determined based on the volatility input applicable to the cap amount; see section 8.4.50 for further discussion on call spreads and capped call options.

Interpretive response: In the case of an equity-linked instrument in which a predetermined volatility is used, whether the instrument is precluded from being considered indexed to the entity's own stock depends on how the predetermined volatility input was determined. Because standard option pricing models (e.g. Black-Scholes) use implied volatility as an input (which changes over time), the use of a fixed volatility input is generally not consistent with the pricing of a fixed-for-fixed contract.

However, the inclusion of the predetermined volatility input in the instrument does not preclude an instrument from being considered indexed to the entity's own stock if:

- the purpose of a predetermined volatility input is to avoid the impact that an event causing early termination may have on the volatility input,
- such that the settlement amount does not neutralize the monetary effect on the holder as a result of that event.

For example, a provision in an equity-linked financial instrument that requires the settlement amount to be determined using the same volatility percentage that was used in the initial pricing of the instrument at inception would not preclude the instrument from being considered indexed to the entity's own stock. Subtopic 815-40's Example 19 (see Question 8.8.230) illustrates a scenario in which an instrument is not precluded from being considered indexed to the entity's own stock because the settlement amount is determined based on an assumption that there are no changes to the explicit inputs since inception other than share price and time.

In the case of the capped call option, the settlement amount would normally be calculated based on the fair values of each option component which, among other inputs, incorporate volatility inputs applicable to the respective option components based on the different strike prices. We believe using the same volatility inputs to determine the settlement amount for both option components (i.e. assuming a flat volatility surface) may be consistent with the pricing of a fixed-for-fixed option on equity shares provided that such volatility inputs result in a commercially reasonable fair value of the transaction based on an option pricing model.



Example 8.8.40

Warrant's settlement amount is adjusted to a fixed percentage of the entity's outstanding stock at the time of settlement

Issuer issues warrants that permit Holder to purchase 5% of its outstanding common stock at the time of exercise, for \$15 per share.

The warrants have a 20-year term, and become exercisable only once Issuer's share price exceeds \$15 per share.

Application of indexation guidance

Step 1

The exercise contingency is Issuer's achievement of a share price of \$15 per share, which is based on an observable index calculated or measured solely by reference to Issuer's own operations.

Therefore, because the index can only be calculated or measured by reference to Issuer's share price, the exercise contingency does not preclude the warrants from being considered indexed to the entity's own stock.

As a result, Issuer now analyzes the instrument under Step 2 of the indexation guidance.

Step 2

Issuer determines that the settlement provisions do not meet the fixed-for-fixed requirement because the number of Issuer's outstanding shares at the time of Holder's exercise affects the settlement amount of the warrants (since Holder is entitled to 5% of all outstanding shares of Issuer at the time of exercise). The number of Issuer's outstanding shares is not an input to the fair value of a fixed-for-fixed instrument.

To illustrate, the current share price is \$18 and Issuer has 5 million shares outstanding when Holder exercises the warrant. The settlement amount is \$750,000: 5 million shares \times 5% \times (\$18 - \$15).

However, if Issuer instead has 7.5 million outstanding shares at the time of exercise, the settlement amount would be \$1.125 million: 7.5 million shares \times 5% \times (\$18 - \$15).

As a result, Issuer concludes that the warrants are not indexed to its own stock.



Example 8.8.50

Warrant's settlement amount is adjusted to limit holder owning greater than a specified fixed percentage of the entity's own stock

Issuer issues warrants that permit Holder to purchase 500,000 shares of its common stock for \$5 per share. The warrants have a 20-year term and are exercisable at any time.

Scenario 1: Partial settlement permitted

The provisions of the warrant prohibit Holder from exercising the warrant to purchase shares that would result in Holder owning 5% or more of Issuer's common stock. However, Holder is permitted to partially settle the warrant to

purchase less than 5% of Issuer's outstanding common stock, and defer settling the remaining number of shares until doing so would not result in Holder owning 5% or more.

The provision exists to avoid the local regulatory requirement for Issuer to report any beneficial owner of 5% or more of its total outstanding common stock.

Application of indexation guidance

Step 1	<p>The warrants are only exercisable when, after doing so, Holder will own less than 5% of Issuer's common stock. Because the exercise contingency is based on neither an observable market nor an observable index (see section 8.7) it does not preclude the warrant from being considered indexed to Issuer's own stock.</p> <p>As a result, Issuer now analyzes the instrument under Step 2 of the indexation guidance.</p>
Step 2	<p>Issuer determines that the settlement provisions are fixed-for-fixed. This is because once fully exercised, the settlement amount of the warrants will equal the difference between:</p> <ul style="list-style-type: none"> — the fair value of 500,000 shares – i.e. a fixed number of Issuer's shares; and — \$2.5 million (500,000 shares × \$5 per share) – i.e. a fixed amount. <p>If not all of the 500,000 shares are delivered to Holder upon exercise because of the 5% limit, Issuer's obligation to deliver the excess shares is not extinguished; Issuer delivers the remaining shares whenever doing so would not violate the 5% limit. The fact that Holder may be required to defer a portion of the settlement to a later date does not affect whether the fixed-for-fixed settlement criterion is met.</p>

As a result, Issuer concludes that the warrants are considered indexed to its own stock.

Scenario 2: Partial settlement not permitted

Unlike Scenario 1, partial settlement of the warrant is not permitted. Instead, upon exercise Issuer is required to net-cash settle the shares owed to Holder that would result in it owning 5% or more of Issuer's common stock.

Because the settlement provisions would still be considered fixed-for-fixed, the warrants would still be considered indexed to Issuer's own stock. However, as explained in section 8.10.10, because Issuer could be required to cash-settle a portion of the warrants, the requirements of the equity classification guidance would not be met and equity classification would be precluded.



Question 8.8.110

What are some example settlement adjustments that are inconsistent with a fixed-for-fixed contract?

Interpretive response: Even if the settlement amount of an instrument could be adjusted based only on inputs that are used in the pricing of a fixed-for-fixed contract, that instrument is not considered indexed to an entity's own stock if

the adjustment is inconsistent with the pricing of a fixed-for-fixed contract. [815-40-15-7F]

For example: [815-40-15-7F]

- a leverage factor in a contract may allow for adjustments based on multiples of an input to the pricing of a fixed-for-fixed contract;
- the settlement amount of an instrument may be inversely affected by changes in an input to the pricing of a fixed-for-fixed contract (see Subtopic 815-40's Example 14, below); or
- the adjustment results in the instrument being settled at a fixed amount.



Excerpt from ASC 815-40

- > Example 14: Variability Involving Interest Rate Index

55-39 Entity A enters into a forward contract to sell 100 shares of its common stock in 1 year for an amount equal to \$10 per share plus interest calculated at a variable interest rate that varies inversely with changes in the London Interbank Offered Rate (LIBOR) (similar to an "inverse floater," as described in paragraphs 815-15-55-170 through 55-172). The forward contract is not considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.
- b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies inversely with changes in an interest rate index. The inverse floating interest rate feature increases the effects of interest rate changes on the instrument's fair value (that is, the feature increases the instrument's fair value exposure to interest rate changes) when compared to the exposure to interest rate changes of a fixed-for-fixed forward contract.

8.8.50 Evaluating adjustments to the settlement amount based on implicit inputs



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

- > Evaluation of Settlement Provisions (Step 2)

15-7G Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price

exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in the fair value of an equity-linked instrument and changes in the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock.

The pricing of an equity-linked financial instrument is determined assuming certain events or circumstances will or will not occur. Because of this, these instruments often include provisions that adjust the settlement amount if these assumptions are invalidated. These assumptions are called implicit inputs.

As discussed in Question 8.8.20, if the terms of an equity-linked financial instrument allow for any type of adjustment to the settlement amount, the probability of the adjustment occurring is irrelevant when evaluating the instrument under Step 2.

Further, as discussed in Question 8.8.40, any such adjustments must be commercially reasonable. [815-40-15-7C – 15-7F]



Question 8.8.120

What are some common adjustments to implicit inputs that are permitted or prohibited under the indexation guidance?

Interpretive response: The following table summarizes certain events that may occur, and identifies whether an adjustment to the settlement amount of an equity-linked financial instrument in response to the event would preclude an instrument from being considered indexed to the entity's own stock.

Equity classification may not be precluded

- Holder is unable to maintain a standard hedge position in the underlying shares.

Equity classification is precluded

- The occurrence or nonoccurrence of an IPO, unless the adjustment triggered by the IPO, is considered a down-round feature.

Equity classification may not be precluded

- An unanticipated event (such as a merger) causes discontinuities in the price of the underlying shares.
- A dilutive event occurs (such as a stock split).

Equity classification is precluded

- A provision that adjusts the settlement amount (such as a cap on the number of shares) if shareholder approval is not obtained.

For example, a standard implicit assumption is that an investor is able to maintain a standard hedge (i.e. short the stock without incurring transaction costs). Because of the way that the standard valuation models value equity-linked financial instruments, the underlying terms of such instruments often include adjustments to the settlement amount to protect the counterparty's investment against unforeseen events. If an implicit assumption is invalidated – e.g. because the investor incurs transaction costs to short the stock or is unable to maintain a standard hedge position – an adjustment to the settlement amount to neutralize the effect of the implicit assumption being invalidated generally does not preclude the fixed-for-fixed settlement criterion from being met. [815-40-15-7G]

Another common assumption used in the valuation models is that markets are efficient and share price changes are continuous. Because this assumption is implicit in the pricing model, Subtopic 815-40 does not preclude an instrument from being considered indexed to the entity's own stock if the provision allowing for an adjustment to the settlement amount exists only to neutralize the effects of a share price discontinuity – i.e. at least partially offset any gain or loss. Such a discontinuity may occur as a result of certain events such as the entity entering into a merger transaction. [815-40-15-7G]

Such provisions are included in ISDA's master agreements. Consequently, they are incorporated into the terms of many equity-linked financial instruments. Such terms are intended to adjust for the breakage between the gain or loss on an equity derivative contract and the offsetting gain or loss on a hypothetical offsetting hedge position that would result from an event that causes a significant share price discontinuity. They are not intended to compensate for a counterparty's actual hedging losses.

For example, if a commercially reasonable hedge position is based on a delta-neutral strategy, any adjustment to the settlement amount to compensate for losses incurred by the holder is permitted. However, if the counterparty entered into a different hedge strategy and incurred additional losses because of share price discontinuity, any adjustment to the settlement amount of the equity-linked instrument based on the counterparty's actual hedging losses would not be considered to meet Step 2 of the indexation guidance.



Example 8.8.60
Adjustments to the settlement amount arising from implicit inputs to a fixed-for-fixed contract pricing model

On July 15, Year 1, Issuer issues warrants that permit Holder to purchase 50 shares of its common stock for \$15 per share. The warrants expire in 20 years and are exercisable any time.

The terms of the contract allow for an adjustment to the strike price of the warrants if there is a merger announcement involving Issuer. The purpose of the adjustment is to offset the effect that the merger announcement has on the net change in the fair value of the warrants and on an offsetting hedge position in the underlying shares. The strike price adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered into a standard hedge position in the underlying shares to offset the share price exposure from the warrants (see Question 8.8.40).

Application of indexation guidance

Step 1	Step 1 does not apply because the terms of the warrants include no contingent exercise provisions.
Step 2	<p>Issuer determines that the warrants are not fixed-for-fixed because the settlement amount will not always equal the difference between the fair value of a fixed number of shares and a fixed exercise price. This is because of the strike price adjustment arising from a merger announcement.</p> <p>However, an implicit assumption used in the pricing of a fixed-for-fixed contract is that Holder has the ability to maintain a standard hedge position in the underlying shares (which would not be the case if a merger announcement involving Issuer were to occur). Therefore, the provision that adjusts the strike price upon a merger announcement does not preclude the contract from being considered indexed to the entity's own stock.</p>

Further, Issuer determines that the provision is written such that the adjustment to the strike price upon a merger announcement is commercially reasonable. This is because the objective of the adjustment is to neutralize any gain or loss Holder would realize based on a standard delta-neutral hedge if a merger is announced.

As a result, Issuer concludes that the warrants are indexed to its own stock, and proceeds to analyze them under the equity classification guidance.



Example 8.8.70
Settlement amount adjusted based on a triggering event

Issuer issues warrants on July 15, Year 1 that permit Holder to purchase 20 shares of its common stock for \$25 per share. However, if Issuer executes an IPO, Holder can require Issuer to settle the warrant for \$2,000. Issuer has been

considering executing an IPO someday, but currently has no imminent plans to pursue it. The warrants have a 20-year term and are exercisable at any time.

Application of indexation guidance

Step 1	Although this example includes an additional provision that applies if Issuer executes an IPO, this is not a contingent exercise provision that needs to be evaluated under Step 1, because the warrants are still exercisable at any time.
Step 2	<p>The settlement amount of the warrant will be adjusted to a fixed amount if Issuer executes an IPO – regardless of the fact that an IPO is currently unlikely, and Issuer controls the decision of whether to go ahead with an IPO.</p> <p>Therefore, Issuer concludes that the settlement provisions of the warrants are not fixed-for-fixed. This is because – consistent with Subtopic 815-40's Example 10 (see Question 8.8.20) – a provision that may result in a fixed settlement amount that is not based on Issuer's share price does not meet the fixed-for-fixed requirement.</p>

As a result, Issuer concludes that the warrants are not indexed to its own stock.



Question 8.8.130

Does the existence of a bail-in provision preclude an equity-linked financial instrument from being considered indexed to the entity's own stock?

Background: The Bank Recovery and Resolution Directive (BRRD) provides European Union (EU) resolution authorities in EU member states with various tools to resolve failing financial institutions. One alternative EU regulators may use is the 'bail-in' authority. The bail-in authority enables EU regulators to write down liabilities of certain financial institutions in the scope of the BRRD and/or convert those liabilities into the equity of the financial institution. With certain exceptions, the bail-in authority applies to all liabilities of an EU bank.

EU regulators were concerned about the enforceability of the bail-in authority when contracts entered into by EU banks are governed by laws outside of EU jurisdictions. Article 55 of the BRRD addresses this concern by requiring EU banks to include a contractual term ('the bail-in provision') within most agreements they enter into after January 1, 2016 that are governed by laws outside of the EU. Specifically, the law requires that the bail-in provision incorporate these mandatory elements:

- acknowledgement that certain liabilities created by the agreement may be subject to bail-in; and
- agreement by parties that they will be bound by the exercise of any bail-in powers by the relevant resolution authority with respect to all transactions under the agreement.

For example, a US branch of Bank (domiciled in France) enters into an ASR program with Company A (domiciled in the United States), with the contractual terms of the ASR being subject to New York law. Article 55 of the BRRD would

require the ASR to include the bail-in provision because Bank is an EU financial institution subject to the BRRD.

EU regulators may impose penalties on EU financial institutions that do not include the bail-in provision in contracts that are governed by laws of a non-EU jurisdiction. Contracts governed under EU laws do not need a bail-in provision because the bail-in powers are legally recognized within EU member states.

Interpretive response: Based on informal discussions with the SEC staff, we understand that the staff would not object to a determination that bail-in provisions, in and of themselves, do not preclude an equity instrument from being considered indexed to the entity's own stock and classified in equity. The staff has noted that, if none of the other terms of the equity instrument preclude it from being considered indexed to the entity's own stock, bail-in provisions in isolation would not preclude the equity instrument from being considered indexed to the entity's own stock.

The SEC staff also communicated that it would not object if an entity previously concluded that including the bail-in provision did preclude the equity derivative from being considered indexed to the entity's own stock. As a result, entities should document their analysis of the provision and conclusions under Subtopic 815-40 and apply that analysis consistently.



Question 8.8.140

Does a conversion ratio adjustment feature for third-party tender offers in a convertible debt indenture preclude the feature from being considered indexed to the entity's own stock?

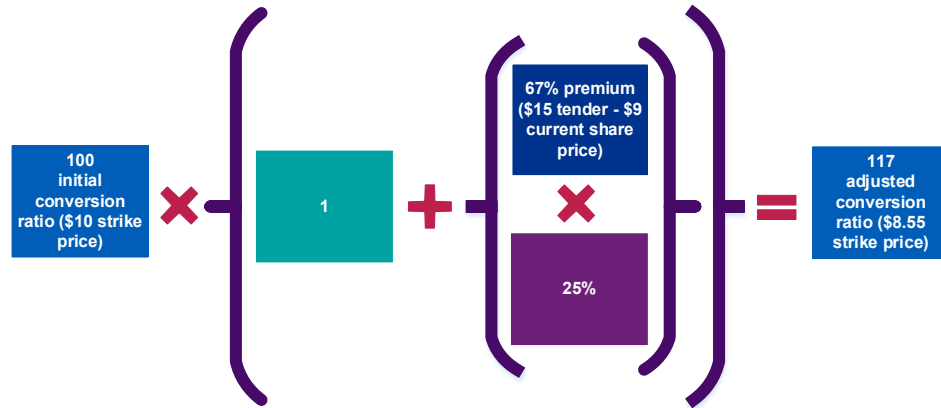
Background: Third-party tender adjustment features are frequently included in the terms of an equity derivative contract. They are generally protective in nature and designed to ensure that equity derivative interest holders are not disadvantaged relative to ordinary shareholders in a tender offer conducted by a shareholder with a significant strategic relationship to the entity. In other words, they serve the same purpose and achieve a comparable effect to adjustment features for tenders initiated by the entity (which are permitted under Subtopic 815-40).

These adjustment clauses generally specify that if a tender offer is completed at a premium price by a third party that results in that third party owning more than a specified portion of the outstanding common stock of the entity, the conversion ratio on the convertible debt adjusts to provide more shares to the convertible debt holder on conversion. The number of additional shares is in proportion to the premium pricing on the tender offer and the number of shares subject to the tender.

For example, Issuer issues convertible debt at par for \$1,000 with a conversion ratio of 100 – i.e. the strike price of the conversion option is \$10 per share. While the convertible debt is outstanding, 25% of the outstanding shares are tendered to a third party for \$15 a share, and the share price is \$9 a share the day after completion of the tender. The result of the tender offer is that Issuer's current common shareholders have the ability to sell their shares for \$15 each.

However, because the current share price of \$9 is below the strike price of the conversion option of \$10 per share, the convertible debt holders are unable to exercise the conversion option.

The adjusted conversion ratio is calculated as follows.



The new conversion ratio is 17% higher than the initial conversion ratio (and, conversely, the new strike price is lower). This is because each shareholder would have received, on average, a 17% premium on their pre-tender common stock position, consisting of a 67% premium (\$6 premium above the \$9 share price) times 25% of the shares that were tendered. The adjustment is only available for non-hostile premium tenders, as determined by the board of directors. Moreover, the laws of the relevant jurisdiction specify that tender offers must be conducted in a manner that does not favor one shareholder at the expense of another – i.e. the tender must be available to all holders of the class in a proportionate manner.

Interpretive response: No. Although a provision for a third-party tender offer adjustment is not specifically discussed in Subtopic 815-40, we believe the guidance contains principles that suggest such a provision is consistent with equity classification.

Specifically, the following three factors suggest that such an adjustment feature is consistent with the requirements of the indexation guidance.

- **Proportionality.** The fundamental principle of the indexation guidance is that the contract varies in value with changes in the payoff on stock. The tender offer provision conveys a benefit that is provided to all common shareholders equally and does not favor certain beneficial interests, because transactions contemplated in Issuer's indenture must be made available to all common shareholders proportionately. This proportionality distinguishes this adjustment feature from other contingent adjustment features that may benefit one class of investors over the others.
- **Implicit input.** Tender offers at an above market price are dilutive events not contemplated in standard pricing models for equity-linked instruments. Therefore, they represent an invalidation of an implicit input to the pricing model and it is appropriate to adjust a fixed-for-fixed settlement amount formula for their direct effects (see section 8.8.50). Subtopic 815-40's Example 17 (see Question 8.8.150) specifically contemplates a repurchase

by an entity of its own stock at an above market price and an adjustment to the strike price of the equity-linked instrument for such dilutive events that does not violate the indexation guidance.

- **Direct effects.** The mathematical calculation of the adjustment is commensurate with the direct effects of the tender offer. In the background example, each of Issuer's common shareholders would have received, on average, a 17% premium on their pre-tender stock position. Therefore, the adjustment feature in the convertible debt instrument also results in a 17% premium provided to each debt holder (via a 17% increase to the conversion ratio).

By comparing the tender offer price to the price of the common stock immediately after completion of the tender (the formula uses the closing price on the business day after the tender), the formula identifies the direct benefit provided to common shareholders by the third-party tender.

We believe it is important that the formula be designed to reasonably capture the direct effects of the implicit input so that the adjustment feature does not inadvertently introduce new underlyings unrelated to equity and equity derivative valuation models in the settlement calculation.

8.8.60 Other considerations when evaluating an instrument under Step 2 of the indexation guidance

Down-round provisions and standard antidilution provisions



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

15-5D When classifying a financial instrument with a **down round feature**, the feature is excluded from the consideration of whether the instrument is indexed to the entity's own stock for the purposes of applying paragraphs 815-40-15-7C through 15-7I (Step 2).

20 Glossary

Down Round Feature

A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce

the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

Equity Restructuring

A nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.

Standard Antidilution Provisions

Standard antidilution provisions are those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the value of the conversion option.



Question 8.8.150

What is a down-round feature and how does it differ from a standard antidilution provision?

Interpretive response: A down-round feature is a provision in an equity-linked financial instrument that reduces the strike price of the instrument if the entity:

- sells additional shares of its common stock for an amount less than the current strike price of the instrument; or
- issues another equity-linked financial instrument with a strike price that is less than the currently stated strike price of the instrument.

The terms of the feature may reduce the strike price to the current issuance price or to another price based on a formula provided for in the contract. [\[815-40 Glossary\]](#)

A down-round feature protects certain investors from a decline in an entity's share price. Although a down-round feature is not normally a significant driver of the fair value of an equity-linked financial instrument, the instrument's fair value is somewhat greater than a similar equity-linked instrument without a down-round feature.

A down-round feature can take many forms. Specifically, it can:

- reduce the strike price of a financial instrument to the current issuance price;
- limit the reduction in strike price by a floor or on the basis of a formula that results in a strike price that is at a discount to the original exercise price but above the new issuance price of the shares; or
- reduce the strike price to below the current issuance price.

Examples 8.8.80 and 8.8.90 illustrate a standard antidilution provision and a down-round provision, respectively. Subtopic 815-40's Example 9 (below) also illustrates an equity-linked financial instrument with a down-round provision.

In contrast, an antidilution provision results in adjustments to the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the value of the conversion option. For purposes of applying this

guidance, an equity restructuring is a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying the instrument to change. This includes transactions such as stock dividends, stock splits, spinoffs, rights offerings or recapitalization through a large, nonrecurring cash dividend. [815-40 Glossary]

Subtopic 815-40's Example 17 (below) illustrates an equity-linked financial instrument with standard antidilution provisions that adjust the settlement amount of the instrument if events occur that a standard valuation model assumes will not occur, including dividends, a stock split, spinoff, rights offering or recapitalization through a large nonrecurring cash dividend.

Because the provisions indicate the purpose of the adjustment is to offset the impact of the event occurring, the instrument is not precluded from being considered indexed to the entity's own stock. The provisions also allow for an adjustment to offset the effect if the entity either issues shares for an amount below, or repurchases shares for an amount above, the then-current market price of its shares. This is also a standard antidilution provision.



Excerpt from ASC 815-40

- > Example 9: Variability Involving Future Equity Offerings and Issuance of Equity-Linked Financial Instruments

55-33 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5 for a financial instrument that includes a **down round feature**. Entity A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify both of the following:

- a. If the entity sells shares of its common stock for an amount less than \$10 per share, the strike price of the warrants is reduced to equal the issuance price of those shares.
- b. If the entity issues an equity-linked financial instrument with a strike price below \$10 per share, the strike price of the warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument.

55-34 The warrants are considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.
- b. Step 2. In accordance with paragraph 815-40-15-5D, when classifying a financial instrument with a down round feature, an entity shall exclude that feature when considering whether the instrument is indexed to the entity's own stock for the purposes of applying paragraphs 815-40-15-7C through 15-7I (Step 2). The instrument does not contain any other features to be assessed under Step 2.

55-34A See paragraph 260-10-45-12B for earnings-per-share considerations, paragraph 260-10-25-1 for recognition considerations, and paragraphs 505-10-50-3 through 50-3A for disclosure considerations.

• > Example 17: Variability Involving Various Underlyings

55-42 Entity A enters into a forward contract to sell 100 shares of its common stock for \$10 per share in 1 year. Under the terms of the forward contract, the strike price of the forward contract would be adjusted to offset the resulting dilution (except for issuances and repurchases that occur upon settlement of outstanding option or forward contracts on equity shares) if Entity A does any of the following:

- a. Distributes a stock dividend or ordinary cash dividend
- b. Executes a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend
- c. Issues shares for an amount below the then-current market price
- d. Repurchases shares for an amount above the then-current market price.

The contractual terms that adjust the forward contract's strike price are eliminating the dilution to the forward contract counterparty that would otherwise result from the occurrence of those specified dilutive events. The adjustment to the strike price of the forward contract is based on a mathematical calculation that determines the direct effect that the occurrence of such dilutive events should have on the price of the underlying shares; it does not adjust for the actual change in the market price of the underlying shares upon the occurrence of those events, which may increase or decrease for other reasons.

55-43 The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.
- b. Step 2. The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and \$1,000 (\$10 per share) are upon the occurrence of any of the following:
 1. The distribution of a stock dividend or ordinary cash dividend
 2. The execution of a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend
 3. The issuance of shares for an amount below the then-current market price
 4. The repurchase of shares for an amount above the then-current market price.

An implicit assumption in standard pricing models for equity-linked financial instruments is that such events will not occur (or that the strike price of the instrument will be adjusted to offset the dilution caused by such events). Therefore, the only variables that could affect the settlement amount in this example would be inputs to the fair value of a fixed-for-fixed option on equity shares.



Question 8.8.160

Does the existence of a down-round feature in and of itself cause an equity-linked financial instrument to fail the indexation guidance?

Interpretive response: No. The settlement of a financial instrument with a down-round feature can be affected by the market price of future equity offerings, or by the contractual terms of other equity-linked financial instruments issued by an entity in a subsequent period. When analyzed under Step 2 of the indexation guidance, the adjustment of the strike price that occurs upon the sale of common stock or an equity-linked financial instrument is not an input to the fair value of a fixed-for-fixed option on equity shares.

However, stakeholders asserted that accounting for certain freestanding and embedded instruments as liabilities creates undue complexity, and income statement volatility associated with an entity's own share price that is inconsistent with the economics of the transaction. This is because changes in fair value of an instrument with a down-round feature would be recognized in earnings for both increases and decreases in share price, even though an increase in share price does not cause a down-round feature to be triggered. Therefore, the FASB issued guidance through ASU 2017-11 such that a down-round feature in and of itself does not preclude an instrument from being considered indexed to the entity's own stock. [\[ASU 2017-11.BC20\]](#)

When a down-round feature of a freestanding equity-linked financial instrument or equity-classified convertible preferred share (if the conversion feature has not been bifurcated under other guidance) is triggered, the issuer measures the effect of the down-round feature and accounts for it as a deemed dividend when determining income available to common shareholders in basic EPS. However, that guidance does not apply to convertible debt instruments because an entity discloses fair value information for them, and changes in the down round feature (such as a trigger) should be captured in the fair value measure. See guidance in section 6.18.20 of KPMG Handbook, [Earnings per share](#). [\[260-10-25-1, 45-12B, ASU 2020-06.BC62\]](#)



Question 8.8.170

Is an adjustment to an instrument's strike price upon the downward revision of the strike price of another of the entity's outstanding instruments a down-round feature?

Background: Assume a warrant or convertible instrument contains a down-round feature that reduces the strike price of the issued instrument if the entity sells equity-linked financial instruments with a strike price below the issued instrument's currently stated strike price. However, features of the contract may adjust the strike price for other reasons. These features may not represent down-round protection as defined in US GAAP.

For example, an instrument may specify that its strike price is adjusted upon the downward revision of the strike price of one of the entity's other equity-linked instruments, such as upon a modification of that other instrument. To illustrate, Issuer issues a warrant that allows Holder to purchase Issuer's common stock at a strike price of \$10. The warrant contains provisions that cause an adjustment to the warrant's strike price in any of the following circumstances.

- a. If Issuer issues common stock for less than the warrant's then-current strike price, the warrant's strike price adjusts to an amount equal to the price of the newly issued common stock.
- b. If Issuer issues an equity-linked instrument with a strike price below the warrant's then-current strike price, the warrant's strike price adjusts to an amount equal to the strike price of the newly issued equity-linked instrument.
- c. If the strike price of another equity-linked instrument(s) is modified after issuance to an amount less than the warrant's then-current strike price, the warrant's strike price adjusts to an amount equal to the revised strike price of the other equity-linked instrument.

Interpretive response: In the background example, (a) and (b) above meet the definition of a down-round feature. Issuer therefore ignores these adjustment features when assessing whether the warrant is indexed to its own stock.

However, (c) above does not meet the definition of a down-round feature. A down-round feature reduces the strike price of an issued financial instrument if the entity sells shares of its stock for an amount less than the instrument's current strike price or issues another instrument with a lower strike price than that instrument. Provision (c) is based on neither the sale nor the issuance of stock or a financial instrument. Instead, it is based on the modification of an existing instrument.

Issuer will need to monitor provision (c) to ensure the equity-linked instrument(s) to which it relates remains outstanding. To the extent the referenced equity-linked instrument(s) is no longer outstanding, Issuer reassesses whether the contract is now considered indexed to its own stock.

Based on discussions with the FASB staff, we believe that because a feature such as provision (c) is not a down-round feature and adjusts the strike price of the instrument based on a separate action (i.e. modification of another instrument instead of issuance of an instrument), Issuer would not be able to conclude that the warrant is indexed to its own stock. Therefore, the warrant would be classified as a liability based on Subtopic 815-40's indexation guidance.



Question 8.8.180

Is a provision that reduces the instrument's strike price and simultaneously increases the number of shares to which the holder will be entitled considered a down-round feature?

Background: A warrant may contain provisions that reduce its strike price and simultaneously increase the number of shares that the warrant holders will be entitled to receive on exercise if the entity:

- sells common shares for an amount less than the warrant's currently stated strike price; or
- issues an equity-linked financial instrument with a strike price below the warrant's currently stated strike price.

For example, Issuer issues a warrant with the following terms and conditions.

- The original strike price is \$10.
- If Issuer sells its common shares for less than \$10 per share, the warrant's strike price will be reduced and the number of shares to which Holder will be entitled will increase based on a formula.
- The formula is designed to adjust the strike price to a level that is less than the original strike price, but greater than the price of the subsequent round of financing – i.e. the strike price adjustment will not cause the warrant to be in- or at-the-money.

The number of shares to which Holder will be entitled will increase by a factor equal to the original strike price divided by the adjusted strike price. Therefore, if the original strike price were to be adjusted to \$8, the number of shares to which Holder is entitled would increase by a factor of 1.25 ($\$10 \div \8).

Interpretive response: The down-round guidance is silent as to any simultaneous adjustment to the number of shares that the warrant holder would be entitled to receive. Based on informal discussions with the SEC staff, we believe the down-round feature guidance applies to a warrant that contains such provisions. Therefore, when analyzing the instrument under Step 2 of the indexation guidance, such a provision is disregarded.



Example 8.8.80

Equity-linked financial instrument with a standard antidilution provision

Issuer issues warrants on July 15, Year 1 that permit Holder to purchase 20 shares of its common stock for \$25 per share.

The terms of the contract allow for an adjustment to the strike price of the contract to neutralize the effect to Issuer's share price if there is a stock split. For example, if Issuer executes a 2:1 stock split, the strike price of the instrument will be reduced by half to \$12.50 per share and Holder will be permitted to purchase 40 shares.

Application of indexation guidance

Step 1	Step 1 does not apply because the terms of the warrants include no contingent exercise provisions.
Step 2	<p>Issuer determines that the warrants are not fixed-for-fixed because the settlement amount will not always equal the difference between the fair value of a fixed number of shares and a fixed exercise price.</p> <p>However, because an implicit assumption used in the pricing of a fixed-for-fixed contract is that a stock split will not occur, the provision that adjusts the strike price upon the execution of a stock split does not preclude the contract from being considered indexed to the entity's own equity.</p>

As a result, Issuer concludes that the warrants are indexed to its own stock, and it proceeds to analyze the warrants under the equity classification guidance.



Example 8.8.90

Equity-linked financial instrument with a down-round provision

Issuer issues warrants on July 15, Year 1 that permit Holder to purchase 20 shares of its common stock for \$25 per share. The terms of the warrants specify that if Issuer sells shares of its common stock for an amount less than \$25 per share, the strike price of the warrants is reduced to equal the issuance price of those shares.

The warrants have a 20-year term and are exercisable at any time.

Application of indexation guidance

Step 1	Step 1 does not apply because the terms of the warrants include no contingent exercise provisions.
Step 2	Issuer does not consider the down-round provision when determining whether an equity-linked financial instrument is indexed to its own stock. This instrument does not contain any other features to be assessed under Step 2.

As a result, Issuer concludes that the warrants are indexed to its own stock, and it proceeds to analyze the warrants under the equity classification guidance.



Question 8.8.185**

Would a 'Most Favored Nations' clause impact classification of an equity-linked or hybrid financial instrument?

Background: A Most Favored Nations (MFN) clause is sometimes present in the terms of financial instruments. It is included in agreements to provide protection to the current holder of the instrument. If the issuer of the

instrument offers more favorable terms in a subsequent issuance of a similar instrument, the MFN clause ensures that the terms of the current instrument automatically update to match the more favorable terms of the new instrument. The MFN adjustment(s) can apply to various types of terms or features of the financial instrument, not just strike price; therefore, an MFN clause may not meet the criteria to be considered a down-round feature (as described in Question 8.8.150).

Interpretive response: It depends.

If an MFN clause is included in an equity-linked financial instrument, evaluate whether the clause would meet the equity classification requirements under ASC 815-40.

If an MFN clause is included in a convertible debt, determine whether it is part of the conversion feature and requires bifurcation based on the terms of the instrument or whether it is a separate embedded feature that requires bifurcation.

Delivery of unregistered shares



Question 8.8.190**

How does an issuer consider a settlement feature of an equity-linked financial instrument that permits delivery of unregistered shares?

Background: An equity-linked financial instrument may be issued with a feature that permits settlement in unregistered shares. These instruments may contain a provision that increases the exchange rate when the issuer settles in unregistered shares or due to the existence of other conditions (e.g. when an issuer is in default of its obligations under a registration rights agreement). The increase in the exchange rate is typically meant to compensate the holder for exposure to additional market risk due to settlement in unregistered shares.

Interpretive response: We believe an entity should consider the nature of the unregistered share settlement feature under Step 2 of the indexation guidance in Subtopic 815-40 because any adjustment to the exchange rate for delivery of unregistered shares requires careful analysis to determine whether they are permissible under that guidance (see Question 8.8.30).



Example 8.8.100**

Evaluating a discount to deliver unregistered shares under Step 2 of the indexation guidance in Subtopic 815-40

Issuer issues convertible notes, each with a par value of \$1,000 that, on exchange, entitle Holder to 20 shares of common stock. The terms of the instrument allow the Holder to exercise at any time. Issuer has the option to

net-cash settle the contract or settle in registered or unregistered common shares. If unregistered shares are delivered by Issuer at settlement, the exchange rate is adjusted by a fixed amount. Based on the contractual provisions, the exchange rate is increased by 5% if Issuer delivers unregistered shares.

Holder exchanges \$1,000 par value convertible notes and Issuer elects to settle in common shares. The exchange rate is increased by 5% for each \$1,000 par value, entitling Holder to 21 shares of unregistered common stock.

The adjustment to the exchange rate is meant to compensate the holder for the additional market risk borne by holding unregistered shares. However, because this adjustment is fixed at issuance, the adjustment does not represent a permitted adjustment under Subtopic 815-40 and causes the exchange feature to fail Step 2 of the indexation guidance. To be a permitted adjustment, the adjustment to the exchange rate must be through a mechanism to ensure it is a commercially reasonable liquidity discount at the settlement date of the instrument. [815-40-15-7E]

Modification of an equity-linked financial instrument



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

- > Evaluation of Settlement Provisions (Step 2)

15-7H Some equity-linked financial instruments contain provisions that provide an entity with the ability to unilaterally modify the terms of the instrument at any time, provided that such modification benefits the counterparty. For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2, such provisions do not affect the determination of whether an instrument (or embedded feature) is considered indexed to an entity's own stock.



Question 8.8.200

How is the issuer's ability to modify an equity-linked financial instrument analyzed under the indexation guidance?

Interpretive response: If an equity-linked financial instrument includes terms that allow the issuer to modify the instrument at any time provided such modifications benefit the counterparty, then these terms do not preclude the instrument from being considered indexed to the entity's own stock. [815-40-15-7H]

For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2 of the indexation guidance, such provisions do not affect the determination of whether an equity-linked financial instrument is considered indexed to an entity's own stock.

Strike price denominated in a foreign currency



Excerpt from ASC 815-40

• • > Strike Price Denominated in a Foreign Currency

15-71 The issuer of an equity-linked financial instrument incurs an exposure to changes in currency exchange rates if the instrument's strike price is denominated in a currency other than the functional currency of the issuer. An equity-linked financial instrument (or embedded feature) shall not be considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency). The determination of whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.



Question 8.8.210

How is the indexation guidance affected if an equity-linked financial instrument's strike price is denominated in a foreign currency?

Interpretive response: An equity-linked financial instrument is not considered indexed to the entity's own stock if the strike price is denominated in a currency other than the entity's functional currency. Subtopic 815-40's Examples 11 and 18 (below) illustrate warrants and a forward contract, respectively, whose strike prices are each denominated in a currency other than the entity's functional currency. [\[815-40-15-71\]](#)

In contrast, determining whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency in which the underlying shares trade. Example 20 of Subtopic 815-40 (below) illustrates an instrument that is considered indexed to the entity's own stock because, while the entity's shares only trade in US dollars, both the entity's functional currency and the instrument's strike price is the Chinese yuan. [\[815-40-15-71\]](#)

Additional examples illustrating this requirement are included after these Subtopic 815-40 examples.



Excerpt from ASC 815-40

- > Example 11: Variability Involving a Currency Other Than the Entity's Functional Currency

55-36 Entity A, whose functional currency is U.S. dollars (USD), issues warrants with a strike price denominated in Canadian dollars (CAD). The warrants permit the holder to buy 100 shares of its common stock for CAD 10 per share. Entity A's shares trade on an exchange on which trades are denominated in CAD. The warrants have 10-year terms and are exercisable at any time. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.
- Step 2. The strike price of the warrants is denominated in a currency other than the entity's functional currency, so the warrants are not considered indexed to the entity's own stock.

- > Example 18: Variability Involving Forward Contract Settled in a Currency Other Than the Entity's Functional Currency

55-44 Entity A, whose functional currency is US\$, enters into a forward contract that requires Entity A to sell 100 shares of its common stock for 120 euros per share in 1 year. The forward contract is not considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.
- Step 2. The strike price of the forward contract is denominated in a currency other than the entity's functional currency, so the forward contract is not considered indexed to the entity's own stock.

- > Example 20: Variability Involving Functional Currency Debt Convertible to a Stock That Trades in a Currency Other Than the Entity's Functional Currency

55-47 Entity A, whose functional currency is the Chinese yuan (CNY), issues a debt instrument denominated in CNY with a par value of CNY 1,000 that is convertible into 100 shares of its common stock. Entity A's shares only trade on an exchange in which trades are denominated in US\$. Those shares do not trade on an exchange (or other established marketplace) in which trades are denominated in CNY. The convertible debt instrument has a 10-year term and is convertible at any time. The embedded conversion option is considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The embedded conversion option does not contain an exercise contingency. Proceed to Step 2.
- Step 2. Upon exercise of the embedded conversion option, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price denominated in its functional currency (CNY 1,000 fixed par value of the debt). The determination of whether the embedded conversion option is indexed to the entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.



Example 8.8.110

Strike price not denominated in the entity's functional currency

Issuer's functional currency is the US dollar (USD). Issuer issues warrants on July 15, Year 1 that permit Holder to purchase 20 shares of its common stock for 500 Mexican pesos (MXN) per share. The strike price is in MXN as opposed to USD because Issuer's shares are listed on an exchange that executes trades that are only denominated in MXN.

Application of indexation guidance

Step 1	Step 1 does not apply because the terms of the warrants include no contingent exercise provisions.
Step 2	Issuer determines that the warrants are not fixed-for-fixed because the strike price of the warrants is denominated in a currency other than its functional currency.

As a result, Issuer concludes that the warrants are not indexed to its own stock.



Example 8.8.120

Strike price denominated in a currency other than that in which the shares trade

On March 15, Year 1, Issuer enters into a forward contract to sell 200 shares of its common stock for \$20 a share in one year (on July 15, Year 2). Issuer's functional currency is the US dollar (USD). However, Issuer's shares only trade on an exchange where trades are denominated in euros.

Application of indexation guidance

Step 1	Step 1 does not apply because the terms of the forward contract include no contingent exercise provisions.
Step 2	Issuer determines that the settlement provisions are fixed-for-fixed because, on exercise, the settlement amount will equal the difference between the fair value of a fixed number of shares and a fixed amount denominated in Issuer's functional currency of USD.

As a result, Issuer concludes that the warrants are indexed to its own stock, and it proceeds to analyze the warrants under the equity classification guidance.

The fact that Issuer's shares only trade on an exchange where the trades are not denominated in its functional currency is irrelevant to the evaluation.

Contracts on convertible preferred stock



Question 8.8.220

How is a warrant to purchase a fixed number of convertible preferred shares for a fixed amount of cash analyzed under the indexation guidance?

Background: Issuer sells a warrant to purchase 100 shares of preferred stock for \$5 a share. The underlying preferred shares are convertible to common shares on a one-for-one basis. The terms of the instrument specify that the conversion price is reduced by \$0.50 after any year in which Issuer does not achieve EBITDA of at least \$100 million. The preferred shares underlying the warrants are not redeemable and would qualify for classification as permanent equity under paragraph 480-10-S99-3A (see section 7.3.20). Step 1 of the indexation guidance does not apply because the instrument does not contain any contingent exercise provisions.

Interpretive response: Using the background example to illustrate, we believe there are two acceptable views.

- **View A.** The settlement amount of the warrant on preferred shares equals the difference between the fair value of a fixed number of *preferred shares* and a fixed monetary amount (i.e. fixed-for-fixed) and therefore the warrant is not precluded from being considered indexed to the entity's own stock.
- **View B.** Because the price to convert Issuer's preferred shares to common shares is adjusted if Issuer does not achieve an EBITDA target, the warrant (through the purchase of preferred stock) is not considered indexed to the entity's own stock. This is because the strike price adjustment is based on EBITDA, which is not an input into the valuation of a fixed-for-fixed instrument.

We believe both views are acceptable as long as the preferred shares in question are substantive – i.e. an entity could not insert a nonsubstantive intermediate security into a warrant to avoid the fixed-for-fixed guidance in Subtopic 815-40. However, once an entity has elected its accounting policy, it should apply that policy consistently to similar transactions in future periods.

Adjustments based on a table

Adjustments to equity-linked financial instruments are sometimes based on a pre-determined table.



Question 8.8.230

Do adjustments based on a table preclude an equity-linked instrument from being considered indexed to the entity's own stock?

Interpretive response: It depends. Equity-linked financial instruments will often include adjustment provisions such as those outlined in Example 19 of Subtopic 815-40 (below).

Such provisions do not preclude an instrument from being considered indexed to the entity's own stock as long as the table was designed such that the aggregate fair value of the shares deliverable would be expected to approximate the fair value of the convertible debt instrument at the settlement date, assuming no change in relevant pricing inputs (other than share price and time) since the instrument's inception.

Generally, the table should be designed to compensate the holder for the lost time value of the option as a result of the event. Therefore, the table should be designed such that:

- the compensation to the holder is directionally consistent with the initial time value component of the option – i.e. the number of additional shares that the holder receives decreases as the share price increases, and decreases as the time to maturity of the convertible debt instrument decreases; and
- there is no evidence of leverage or compensation to the holder that is unrelated to the time value component of the option.



Excerpt from ASC 815-40

- > Example 19: Variability Involving Contingently Convertible Debt with a Market Price Trigger, Parity Provision, and Merger Provision

55-45 Entity A issues a contingently convertible debt instrument with a par value of \$1,000 that is convertible into 100 shares of its common stock. The convertible debt instrument has a 10-year term and is convertible at any time after any of the following events occurs:

- Entity A's stock price exceeds \$13 per share (market price trigger).
- The convertible debt instrument trades for an amount that is less than 98 percent of its if-converted value (parity provision).
- There is an announcement of a merger involving Entity A.

55-46 The terms of the convertible debt instrument also include a make-whole provision. Under that provision, if Entity A is acquired for cash before a specified date, the holder of the convertible debt instrument can convert into a number of shares equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined by reference to a table with axes of stock price and time. That table was designed such that the aggregate fair value of the shares deliverable

(that is, the fair value of 100 shares per bond plus the make-whole shares) would be expected to approximate the fair value of the convertible debt instrument at the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the instrument's inception. The embedded conversion option is considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The market price trigger and parity provision exercise contingencies are based on observable markets; however, those contingencies relate solely to the market prices of the entity's own stock and its own convertible debt. Also, the merger announcement exercise contingency is not an observable market or an index. Therefore, Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.
- b. Step 2. An acquisition for cash before the specified date is the only circumstance in which the settlement amount will not equal the difference between the fair value of 100 shares and a fixed strike price (\$1,000 fixed par value of the debt). The settlement amount if Entity A is acquired for cash before the specified date is equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a fixed-for-fixed option on equity shares.



Question 8.8.240

Does the inclusion of a 'tax cap' in a capped call transaction preclude the instrument from being considered indexed to the entity's own stock?

Background: As discussed in section 8.4.50, sometimes the terms of a capped call transaction may include a cap on the amount due to the issuer if the capped call is settled early because the related debt is converted early. Such a provision is referred to as a 'tax cap'.

Interpretive response: We believe the inclusion of a tax cap in a capped call transaction generally does not preclude an instrument from being considered indexed to the entity's own stock because the inputs to the settlement amount of the instrument that are adjusted as a result of a tax cap are generally allowable adjustments under Step 2 of the indexation guidance. Further, the provisions of a tax cap include a ceiling on the settlement amount of the capped call transaction.

For example, Issuer issues \$400 million worth of \$1,000 convertible notes. Concurrently, Issuer enters into a capped call transaction with Bank for 400,000 options. The provisions of the capped call transaction make reference to a 'synthetic debt instrument' for tax purposes and indicate an initial carrying amount of the synthetic debt instrument of \$362.8 million. For tax purposes, the difference between the initial carrying amount and the \$400 million par value of the convertible notes represents premium paid for the capped call

options (i.e. the fair value), which are accreted back up to the par value of the convertible notes over the life of the notes and the capped call options.

The provisions of the capped call transaction indicate that, upon early conversion of the convertible notes, Bank will deliver to Issuer cash or shares for a total value equal to the value of consideration given to the note holders upon early conversion, less the carrying amount of the synthetic debt instrument at the time of the early conversion. Further, the value of consideration to be provided to Issuer by Bank is capped at the value of the corresponding consideration delivered to the note holders upon early conversion (i.e. the tax cap).

The inputs to the calculation of consideration due by Bank to Issuer upon early conversion (i.e. the settlement amount) are adjusted based on the passage of time and the implicit interest rate of the synthetic debt instrument. Because both of these variables are inputs into the fair value of a fixed-for-fixed instrument, adjustments to them are allowable under Step 2 of the indexation guidance. Further, the tax cap ensures that Issuer cannot receive more value from Bank upon settlement than it owes to the convertible note holders; if Issuer could receive more, we believe it would preclude the instrument from being considered indexed to Issuer's own stock.

The settlement amount of instruments such as these is often summarized in a table that indicates the carrying amount of the synthetic debt instrument at a given date, which is based on the implicit interest rate of the instrument. Such a table can be analogized to the table referred to in Example 19 of Subtopic 815-40 (above). Similar to Example 19, because the variables affecting the amounts illustrated in the table in a tax integrated capped call transaction are inputs into the fair value of a fixed-for-fixed instrument, adjustments to them do not preclude the instrument from being considered indexed to the entity's own stock.

Adjustments based on holder's characteristics



Question 8.8.250

Do settlement amount adjustments based on who holds an equity-linked instrument preclude it from being considered indexed to the entity's own stock?

Interpretive response: Yes. Certain equity-linked instruments include terms that provide for changes to the settlement amount depending on the characteristics of the instrument's holder. As a result, the instrument does not have a fixed-for-fixed settlement amount. The SEC staff has indicated that such terms preclude the warrants from being indexed to the entity's own stock because an instrument's holder is neither: [SEC statement (4/12/21)]

- an explicit input used in the pricing of a fixed-for-fixed forward or option contract on equity shares (see section 8.8.40); nor

- an implicit input or assumption used in standard pricing models for equity-linked financial instruments (see section 8.8.50).

In our experience, a SPAC may issue certain warrants to its sponsors (the 'private warrants') that have provisions changing the terms and characteristics of the warrants to those of the warrants issued by the SPAC to the public (the 'public warrants') if the sponsors transfer the warrants to the public. In this case, the settlement amount of the private warrants can vary depending on who holds those warrants (the sponsors or the public). See Example 8.8.130.



Example 8.8.130

Warrant's settlement amount is adjusted depending on who holds it

Scenario 1: Settlement amount of public warrants depends on who holds warrant

SPAC issues warrants to the public (public warrants) to purchase 100 of SPAC's Class A common shares. The warrants are in the scope of Subtopic 815-40.

The public warrants are redeemable – at SPAC's option – for \$0.10 per warrant if the Class A share price equals or exceeds \$10 per share. If SPAC elects to redeem the warrants, the holders may choose to exercise the warrants during the redemption period on a cashless basis.

However, the settlement amount varies depending on who holds the public warrants.

- **Holder is a SPAC director or officer (or a permitted transferee).** The settlement amount (i.e. the number of shares) is based on the public warrant's closing price on a specified date. Question 8.8.90 explains that contracts that require settlement at fair value are not precluded from being considered indexed to the entity's own stock.
- **Holder is anyone other than a SPAC director or officer (or a permitted transferee).** The settlement amount is determined using a make-whole table that prescribes the amount of compensation the holder would receive depending on axes of Class A share price and remaining time to maturity of the warrants. The number of shares includes compensation for lost time value if a settlement occurs when the Class A share is below a stated value (e.g. \$18). Question 8.8.230 explains that if a settlement amount determined using a make-whole table meets all of the requirements in Example 19 of Subtopic 815-40, the warrants would not be precluded from being considered indexed to the entity's own stock.

The indexation guidance is applied to this arrangement as follows.

Step 1

SPAC's ability to redeem the warrants at \$0.10 per warrant when the Class A share price equals or exceeds \$10 per share is an exercise contingency.

Because the event triggering the redemption feature is not an observable market or an observable index that is unrelated to SPAC's

	<p>stock price, the exercise contingency does not preclude the warrants from being considered indexed to an entity's own stock.</p> <p>As a result, SPAC now analyzes the instrument under Step 2 of the indexation guidance.</p>
Step 2	<p>The fact that the characteristics of the warrant's holder changes the settlement amount – i.e. the settlement amount differs depending on whether the holder is a SPAC director or officer – precludes the warrants from being indexed to the entity's own stock.</p> <p>This is the case even if each settlement amount, in isolation, would otherwise be permitted – i.e. even if, in isolation, each adjustment would not preclude considering the warrants to be indexed to the entity's own stock.</p>

As a result, SPAC concludes that all the public warrants are not indexed to its own stock and, therefore, classifies them as a liability.

Scenario 2: Settlement amount of private placement warrants depends on who holds the warrants

SPAC issues two sets of warrants – public warrants and warrants to the SPAC sponsors (private placement warrants). All warrants are in the scope of Subtopic 815-40.

If a change in control occurs and less than 70% of the consideration received by SPAC's shareholders is in the form of stock in the successor entity that is listed on an exchange, the exercise price is reduced; however, the adjustment differs between the public warrants and the private placement warrants.

- **Private placement warrants.** The exercise price is reduced by a stated calculation including a warrant value using the Black-Scholes model for an *uncapped* American call option. However, if the private placement warrants are transferred to a nonpermitted transferee, the exercise price is reduced in the same way as the public warrants.
- **Public warrants.** The exercise price is reduced by a stated calculation including a warrant value using the Black-Scholes model for a *capped* American call option.

In summary, the private placement warrant's settlement amount is based on:

- an *uncapped* American call option if the warrant holder is the SPAC sponsor (or a permitted transferee); or
- a *capped* American call option if the warrant holder is a nonpermitted transferee.

Similar to Scenario 1, the private placement warrants' settlement amount differs depending on the characteristics of the warrant holder. As in the Step 2 analysis in Scenario 1, this fact precludes the private placement warrants from being indexed to the entity's own stock. As a result, SPAC concludes that the private placement warrants are not indexed to its own stock, and therefore it classifies them as liabilities.

However, in Scenario 2, the fact that the private placement warrants' settlement amount differs depending on the holder's characteristics does not preclude the *public* warrants from being indexed to the entity's own stock. This

is because all public warrants, no matter who holds them, will always settle in the same way for this feature.

8.9 Interaction between Step 1 and Step 2 of the indexation guidance



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

- > Evaluation of Contingent Exercise Provisions (Step 1)

15-7B If an instrument's strike price or the number of shares used to calculate the settlement amount would be adjusted upon the occurrence of an exercise contingency, the exercise contingency shall be evaluated under Step 1 (see the preceding paragraph) and the potential adjustment to the instrument's settlement amount shall be evaluated under Step 2 (see the guidance beginning in the following paragraph).

Sometimes a clause in an equity-linked instrument may appear to be a contingent exercise provision to be analyzed under Step 1. However, upon further analysis an entity may determine that the clause is not a contingency because it does not affect whether the instrument is exercisable. Instead, it only affects the settlement amount and therefore requires analysis under Step 2.

Some clauses may need to be analyzed under both Steps 1 and 2. This is the case if a clause affects the holder's ability to exercise and the amount to be settled upon exercise of the instrument.



Example 8.9.10

Contingent exercise provision or adjustment to the settlement amount?

Provision analyzed under Step 1 only

Issuer issues warrants that permit Holder to purchase 100 shares of its common stock for \$5 per share. The warrants have a 20-year term and become exercisable only once Issuer's share price exceeds \$50 a share for a period of 30 consecutive days.

This is only a contingent exercise provision because the warrants' exercise price (i.e. the settlement amount) is not affected by the provision – only the ability or inability to exercise them is affected.

Because the contingent exercise provision is based on a market for Issuer's own stock, it does not preclude the warrants from being considered indexed to

Issuer's own stock. Therefore, Issuer next analyzes the instrument's settlement provisions under Step 2 of the indexation guidance.

Examples 2 and 3 of Subtopic 815-40 (included in Question 8.8.10) are also examples of instruments in which an exercise contingency is only analyzed under Step 1.

Provision analyzed under Step 2 only

Issuer issues another round of warrants. The warrants are exercisable at \$5 a share if Issuer's share price is below \$40 a share. If the share price exceeds \$40, \$45 or \$50 a share, the warrants are exercisable at \$5.50, \$6.25 or \$6.75 a share, respectively.

A sliding scale has been added to the provisions of these warrants, such that the warrants are always exercisable but the exercise price depends on Issuer's share price. In this example, there is no contingent exercise provision that needs to be evaluated under Step 1, because the warrants are always exercisable. However, because the provision affects the settlement amount of the warrants (i.e. the exercise price changes as Issuer's share price changes), the provision must be evaluated under Step 2.

Because the number of shares that will be delivered upon exercise is different depending on Issuer's share price, the warrants' settlement provisions are not considered fixed-for-fixed. However, because the variable that could affect the settlement amount (i.e. Issuer's share price) would be an input to the fair value of a fixed-for-fixed instrument, Issuer concludes that the settlement provisions meet the requirements of Step 2. Therefore, the warrants are considered indexed to Issuer's own stock.

Provision analyzed under Step 1 and Step 2

Issuer issues a third round of warrants. These warrants are not exercisable unless Issuer's share price exceeds \$40 a share. If share price exceeds \$40, \$45, or \$50 a share, the warrants are exercisable at \$5, \$5.50 or \$6.75 a share, respectively.

This example illustrates a provision that is both a contingent exercise provision and a provision affecting the settlement amount. The contingent exercise provision (that needs to be evaluated under Step 1) is that the warrants are only exercisable if Issuer's share price exceeds \$40 a share. The effect to the settlement amount of the warrants (i.e. the price changes as Issuer's share price changes) must be evaluated under Step 2.

Because the contingent exercise provision is based on a market for Issuer's own stock, it does not preclude the warrants from being considered indexed to Issuer's own stock, and Issuer analyzes the warrants under Step 2.

Under Step 2, because the number of shares that will be delivered upon exercise is different depending on Issuer's share price, the warrants' settlement provisions are not considered fixed-for-fixed. However, because the variable that could affect the settlement amount (i.e. Issuer's share price) would be an input to the fair value of a fixed-for-fixed instrument, Issuer concludes that the settlement provisions meet the requirements of Step 2. Therefore, the warrants are considered indexed to Issuer's own stock.



Example 8.9.20
Evaluating a provision under both Step 1 and Step 2 of the indexation guidance

Scenario 1: Conversion has sliding scale

Issuer issues warrants on October 1, Year 1. These warrants have a 10-year term but are not exercisable unless Issuer's rolling 12-month sales exceed \$100 million. If Issuer's rolling 12-month sales exceed \$100 million, \$200 million or \$300 million, the warrants can be exercised for 10, 15 or 50 shares, respectively, for \$10 per share.

Application of indexation guidance

Step 1	Because the contingent exercise provision is based on an index calculated or measured solely by reference to Issuer's own operations (i.e. its sales), existence of the provision does not preclude the warrants from being considered indexed to Issuer's own stock, and Issuer analyzes the warrants under Step 2.
Step 2	Issuer determines that the settlement provisions are not fixed-for-fixed. The settlement amount does not equal the difference between the fair value of a fixed number of Issuer's equity shares and a fixed strike price. The number of shares that would be issued at settlement is not fixed because Holder can purchase more shares as Issuer's rolling 12-month sales increase. In addition, the amount of Issuer's rolling 12-month sales is not an input to the fair value of a fixed-for-fixed option on equity shares.

As a result, Issuer concludes that the warrants are not indexed to its own stock.

Scenario 2: Conversion has no sliding scale

Similar to Example 3 of Subtopic 815-40 (included in Question 8.8.10), the warrants are not exercisable unless Issuer's rolling 12-month sales exceed \$100 million. However, once they are exercisable, Holder can buy 10 shares of Issuer's stock for \$10 per share.

Because there is no sliding scale of shares Holder can purchase when exercising the warrant based on the amount of Issuer's sales, Issuer concludes that the settlement provisions meet the fixed-for-fixed requirement. This is because on exercise, the settlement amount will equal the difference between the fair value of 10 shares (i.e. a fixed number of Issuer's shares) and \$100 (i.e. a fixed amount).



Question 8.9.10

How is the unit of account guidance considered when determining whether a provision is a contingent exercise provision or an adjustment to the settlement amount?

Interpretive response: To answer this question, consider the following scenarios where warrants become exercisable based on whether EBITDA at the end of any quarter during Year 1 meets the specified thresholds.

Scenario 1: Entity issues the following:		Scenario 2: Entity issues the following:
One warrant exercisable for 50 shares if the entity's EBITDA is above \$50 million	One warrant exercisable for 40 shares if the entity's EBITDA is above \$65 million	One warrant that is exercisable as follows: <ul style="list-style-type: none"> — For 50 shares if the entity's EBITDA is \$50 - \$65 million — For 90 shares if the entity's EBITDA is \$65 - \$80 million — For 120 shares if the entity's EBITDA is \$80 - \$95 million — For 140 shares if the entity's EBITDA is above \$95 million
One warrant exercisable for 30 shares if the entity's EBITDA is above \$80 million	One warrant exercisable for 20 shares if the entity's EBITDA is above \$95 million	

Economically, there is no difference between the entity issuing the four separate warrants or the single warrant. However, the unit of account guidance impacts whether such provisions are analyzed only under Step 1 or are also analyzed under Step 2 of the indexation guidance (see section 8.3).

Scenario 1: Four separate warrants are issued

When the entity issues these warrants as four separate instruments that represent four units of account, the provision is evaluated first under the requirements of Step 1 of the indexation guidance. Those requirements are met because EBITDA is neither an observable market nor an index based on something other than the entity's own share price or operations. Because each warrant's settlement amount is for a fixed number of shares, there are no adjustments to the settlement amount and the provision is not analyzed under Step 2 of the guidance (assuming there are no other adjustments to the settlement amount). Therefore, these four warrants would be considered indexed to the entity's own stock.

An entity may structure a transaction as four separate warrants to arrive at this accounting treatment (e.g. classification as equity under Subtopic 815-40). However, the guidance for viewing two or more contracts as a single unit of account in paragraph 815-10-15-8 must be considered.

Scenario 2: One warrant is issued that is exercisable based on a sliding scale

When the entity issues one warrant that includes a sliding scale, the evaluation under the indexation guidance differs depending on whether the warrant represents one or four units of account.

- **One unit of account:** An entity may conclude that the warrant represents one unit of account at issuance (e.g. after considering the guidance for determining whether each exercisability tranche is a freestanding instrument). In this case, the provision is evaluated first under the requirements of Step 1 of the indexation guidance. The Step 1 requirements are met for the same reasons as the four separate warrants in Scenario 1. However, the provision would also require analysis under the requirements of Step 2. The Step 2 requirements would not be met because the variable that could adjust the settlement amount (i.e. EBITDA) is not an input that is used in the pricing of a fixed-for-fixed contract.

In this situation, the entity may evaluate whether the warrant continues to represent one unit of account as it becomes exercisable. For example, assume the entity achieves \$50 million of EBITDA and the warrant becomes exercisable for 50 shares. At that time, the entity may evaluate whether the exercisable portion of the warrant is freestanding (i.e. if the exercisable portion is legally detachable and separately exercisable (see section 6.2.20) from the portion that is not exercisable). If so, the exercisable warrant would be considered indexed to the entity's own stock for the same reasons as in Scenario 1.

- **Four units of account:** An entity may conclude that the warrant is considered to be four separate units of account and evaluate the indexation guidance similar to Scenario 1 (i.e. solely under Step 1). While all of the considerations in determining whether the four warrants are each freestanding instruments must be considered (e.g. if none of the exercisability thresholds are met, the entity has to evaluate whether each of the tranches may be transferred to a third party independent of the other to meet the 'legally detachable and separately exercisable' criterion), we generally believe that arriving at the conclusion that the warrant is four separate units of account is not appropriate if the primary driver of the conclusion is to permit equity classification of the instrument (or to meet the own equity scope exception from derivative accounting) under Subtopic 815-40. This is similar to the requirement in Scenario 1 to consider whether the four separate warrants should be combined into one unit of account under paragraph 815-10-15-8.

8.10 Equity classification guidance: The basic premise

8.10.10 Overview



Excerpt from ASC 815-40

25-1 The guidance in this Section applies for the purpose of determining whether an instrument or embedded feature qualifies for the second part of the scope exception in paragraph 815-10-15-74(a). The first part of the scope exception in paragraph 815-10-15-74(a) is addressed in Section 815-40-15. The

initial balance sheet classification of contracts within the scope of this Subtopic generally is based on the concept that:

- a. Contracts that require **net cash settlement** are assets or liabilities.
- b. Contracts that require settlement in shares are equity instruments.

25-2 Further, an entity shall observe both of the following:

- a. If the contract provides the counterparty with a choice of net cash settlement or settlement in shares, this Subtopic assumes net cash settlement.
- b. If the contract provides the entity with a choice of net cash settlement or settlement in shares, this Subtopic assumes settlement in shares.

25-4 Accordingly, unless the economic substance indicates otherwise:

- a. Contracts shall be initially classified as either assets or liabilities in both of the following situations:
 - 1. Contracts that require net cash settlement (including a requirement to net cash settle the contract if an event occurs and if that event is outside the control of the entity)
 - 2. Contracts that give the counterparty a choice of net cash settlement or settlement in shares (**physical settlement** or net share settlement).
- b. Contracts shall be initially classified as equity in both of the following situations:
 - 1. Contracts that require physical settlement or net share settlement
 - 2. Contracts that give the entity a choice of net cash settlement or settlement in its own shares (physical settlement or net share settlement), assuming that all the criteria set forth in paragraphs 815-40-25-7 through 25-30 and 815-40-55-2 through 55-6 have been met.

If an equity-linked financial instrument meets the requirements of the indexation guidance, it must then be analyzed under the equity classification guidance. A thorough understanding of an instrument's settlement method(s) and other factors about the instrument and the entity is needed to determine whether the instrument meets the requirements of the equity classification guidance.

Equity-linked financial instruments can be settled using a variety of settlement methods, and the issuer or holder may have a choice of settlement methods. Three common methods are as follows.

- **Physical settlement in shares.** The party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer.
- **Net-share settlement.** The party with a loss delivers to the party with a gain shares with a current fair value equal to the gain.
- **Net-cash settlement.** The party with a loss delivers to the party with a gain a cash payment equal to the gain – i.e. no shares are exchanged.



Question 8.10.10
What is the basic premise of the equity classification guidance?

Interpretive response: The basic premise of the equity classification guidance is as follows.

Asset or liability classification	Equity classification (assuming the entity has the ability to deliver shares)
<ul style="list-style-type: none"> — Contract requires net-cash settlement; or — Contract provides the <i>counterparty</i> with the option of net-cash settlement or settlement in shares 	<ul style="list-style-type: none"> — Contract requires settlement in shares; or — Contract provides the <i>issuing entity</i> with the option of net-cash settlement or settlement in shares



Example 8.10.10
Settlement alternatives for an equity-linked financial instrument

This example illustrates the settlement of an instrument under three common methods of settlement.

Issuer issues warrants that permit Holder to purchase 100 shares of its common stock for \$4 per share. The warrants have a 20-year term and are exercisable at any time. The warrants are settled after one year, when Issuer's share price is \$8 per share.

Scenario 1: Physical settlement in shares

If the warrants are physically settled in shares, Holder delivers \$400 (100 shares × \$4 per share) to Issuer and Issuer delivers 100 shares to Holder. Holder paid \$400 for shares currently worth \$800 (100 shares × \$8 per share market price). Therefore, Holder has a gain of \$400: \$800 fair value – \$400 payment.

Scenario 2: Net-share settlement

If the warrants are net-share settled, Issuer delivers 50 shares to Holder. Holder's gain on the settlement of the warrants is the difference between the fair value of the shares on the settlement date of \$800 (100 shares × \$8 per share) and the settlement amount of \$400 (100 shares × \$4 per share). The gain of \$400 equates to 50 shares (\$400 ÷ \$8 per share).

Scenario 3: Net-cash settlement

If the warrants are net-cash settled, Issuer delivers \$400 to Holder. This is the amount of Holder's gain on the settlement of the warrants, calculated as the difference between the fair value of the shares on the settlement date of \$800 (100 shares × \$8 per share) and the settlement amount of \$400 (100 shares × \$4 per share).



Question 8.10.20

How is the equity classification guidance generally affected by standard ISDA provisions often found in equity-linked financial instruments?

Interpretive response: As discussed in section 8.5, contracts on an entity's own equity are frequently drafted using standard agreements developed by the ISDA. Similar to the analysis of these instruments under the indexation guidance, provisions often found in these agreements may impact the accounting treatment of the instrument under the equity classification guidance.

Among other things, these contracts often include provisions that require the instrument to be terminated (or give the holder the right to terminate) upon the occurrence of an extraordinary event (e.g. merger, bankruptcy filing, delisting). The Master Agreement of the contract (which is part of the standard ISDA documentation; see section 8.5) may require net-cash settlement upon the occurrence of such an extraordinary event.

When analyzing an instrument with such a provision under the equity classification guidance, careful consideration of the required settlement method in all circumstances (i.e. including upon early termination) must be performed, regardless of the probability of an event or circumstance occurring. If the occurrence of an event would require net-cash settlement of the instrument and such an event is not within the entity's control, the instrument's settlement provisions are, by extension, also not within the entity's control. Consequently, the requirements of the equity classification guidance are not met.

Often, in order to overcome the requirement to net-cash settle an instrument upon the occurrence of an extraordinary event, the confirmation (another part of standard ISDA documentation) will include language that allows the entity to override the settlement requirements included in any document within the agreement, and in all cases have the ability to choose how the instrument will be settled. Inclusion of such language in the confirmation will generally result in the instrument meeting the equity classification requirements assuming all the other criteria are met (see Section 8.12).

8.10.20 Settlement alternatives that differ in gain and loss positions



Excerpt from ASC 815-40

> Settlement Alternatives Differ in Gain and Loss Positions

25-36 This guidance addresses two circumstances in which settlement alternatives differ in gain and loss positions:

- a. Net cash payment required in loss position
- b. Net-stock alternative in loss position.

- > Net Cash Payment Required in Loss Position

25-37 A contract indexed to, and potentially settled in, an entity's own stock, with multiple settlement alternatives that require the entity to pay net cash when the contract is in a loss position but receive (a) net stock or (b) either net cash or net stock at the entity's option when the contract is in a gain position shall be accounted for as an asset or a liability.

- > Net-Stock Alternative in Loss Position

25-38 A contract indexed to, and potentially settled in, an entity's own stock, within the scope of this Subtopic and with multiple settlement alternatives that require the entity to receive net cash when the contract is in a gain position but pay (a) net stock or (b) either net cash or net stock at the entity's option when the contract is in a loss position shall be accounted for as an equity instrument. This guidance does not apply to a contract that is predominantly a purchased option in which the amount of cash that could be received when the contract is in a gain position is significantly larger than the amount that could be paid when the contract is in a loss position because, for example, there is a small contractual limit on the amount of the loss. Those contracts shall be accounted for as assets or liabilities.

Some equity-linked financial instruments contain settlement provisions that differ when the instrument is in a gain or a loss position for the issuer.



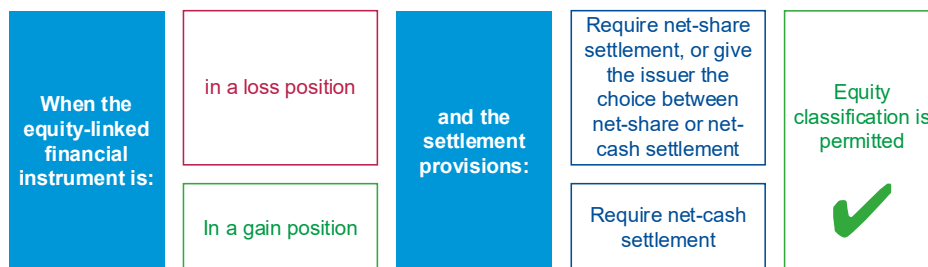
Question 8.10.30

Does a settlement provision that differs when an equity-linked financial instrument is in a gain or loss position preclude equity classification?

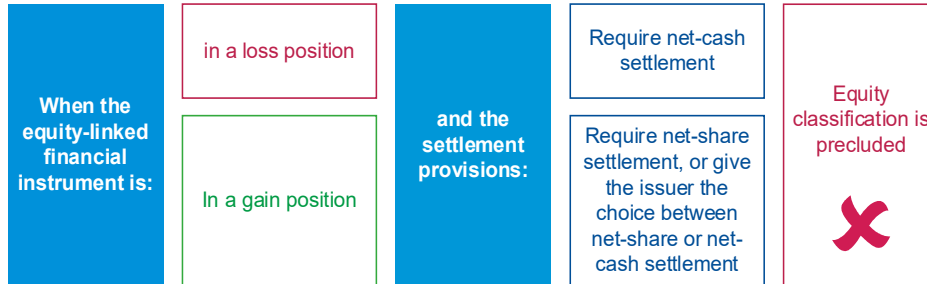
Interpretive response: It depends. An instrument is not precluded from meeting the equity classification guidance if the provision: [815-40-25-38]

- allows the issuer to choose between net-share or net-cash settlement; or
- requires net-share settlement when the instrument is in a loss position but requires net-cash settlement only when the instrument is in a gain position.

However, this guidance cannot be used to justify equity classification for a purchased option contract when the option's purchaser would never be required to pay cash if the option is in a loss position (or could only be required to pay a small amount, e.g. for the premium to purchase the option). [815-40-25-38]



However, if the settlement provisions are structured inversely, the requirements of the equity classification are not met and the instrument is accounted for as an asset or a liability. [815-40-25-37]



In summary, consistent with the general classification principles discussed in section 8.10.10, if the issuer will be required to pay net in cash on settlement of the equity-linked instrument, the instrument is not eligible for equity classification.

8.10.30 Evaluating substance over form



Excerpt from ASC 815-40

25-3 Except as noted in the last sentence of this paragraph, the approach discussed in paragraphs 815-40-25-1 through 25-2 does not apply if settlement alternatives do not have the same economic value attached to them or if one of the settlement alternatives is fixed or contains caps or floors. In those situations, the accounting for the instrument (or combination of instruments) shall be based on the economic substance of the **transaction**. For example, if a **freestanding contract**, issued together with another instrument, requires that the entity provide to the holder a fixed or guaranteed return such that the instruments are, in substance, debt, the entity shall account for both instruments as liabilities, regardless of the settlement terms of the freestanding contract. However, the approach discussed in paragraphs 815-40-25-1 through 25-2 does apply to contracts that have settlement alternatives with different economic values if the reason for the difference is a limit on the number of shares that must be delivered by the entity pursuant to a **net share settlement** alternative.

- • > Detachable Stock Purchase Warrants

55-15 An entity issues senior subordinated notes with a detachable warrant that gives the holder both the right to purchase 6,250 shares of the entity's stock for \$75 per share and the right (that is, a put) to require that the entity repurchase all or any portion of the warrant for at least \$2,010 per share at a date several months after the maturity of the notes in about 7 years. The proceeds should be allocated between the debt liability and the warrant based on their relative fair values, and the resulting discount should be amortized in accordance with Subtopic 835-30. The warrants should be considered, in

substance, debt and accounted for as a liability because the settlement alternatives for the warrants do not have the same economic value attached to them and they provide the holder with a guaranteed return in cash that is significantly in excess of the value of the share-settlement alternative on the issuance date.

If an equity-linked financial instrument contains settlement alternatives that have different 'economic values', the entity must consider the substance of the instrument when evaluating whether the instrument meets the requirements of the equity classification guidance. [815-40-25-3]

The FASB illustrates this concept in paragraph 815-40-55-15 (above). In that example, the warrant is treated as in-substance debt because the value of the warrant is significantly higher than the value of the common stock – i.e. the warrant guarantees a price of at least \$2,010 per share compared to the value of the stock of \$75 per share. Therefore, the warrant's holder is guaranteed \$2,010 per share regardless of the share price, which is like a guarantee to repay debt when a loan is executed. [815-40-25-3, 55-15]

Subtopic 480-10 provides guidance on analyzing freestanding instruments with multiple components – e.g. puttable warrants containing a written call option for the holder to buy the entity's shares and a written put option for the holder to put the warrants back to the entity for cash or other assets. Under that guidance a puttable warrant is liability-classified because it embodies an obligation indexed to an obligation to repurchase an entity's own shares and may require a transfer of assets. Therefore, irrespective of the strike price on the put option, the instrument described in paragraph 815-40-55-15 likely would be a liability under Subtopic 480-10. [480-10-55-31]

8.11 Equity classification guidance – situations in which cash settlement is permitted



Excerpt from ASC 815-40

> Additional Conditions Necessary for Equity Classification

25-7 Contracts that include any provision that could require net cash settlement cannot be accounted for as equity of the entity (that is, asset or liability classification is required for those contracts), except in those limited circumstances in which holders of the underlying shares also would receive cash (as discussed in the following two paragraphs and paragraphs 815-40-55-2 through 55-6).

25-8 Generally, if an event that is not within the entity's control could require net cash settlement, then the contract shall be classified as an asset or a liability. However, if the net cash settlement requirement can only be triggered in circumstances in which the holders of the shares underlying the contract also would receive cash, equity classification is not precluded.

25-9 This Subtopic does not allow for an evaluation of the likelihood that an event would trigger cash settlement (whether net cash or physical), except that if the payment of cash is only required upon the final liquidation of the entity, then that potential outcome need not be considered when applying the guidance in this Subtopic.

- > Additional Conditions for Equity Classification – Net Cash Settlement and Consideration to Holders of Underlying Shares

55-2 An event that causes a change in control of an entity is not within the entity's control and, therefore, if a contract requires **net cash settlement** upon a change in control, the contract generally must be classified as an asset or a liability.

55-3 However, if a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded as a result of the change-in-control provision. In that circumstance, if the holders of the shares underlying the contract were to receive cash in the **transaction** causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract.

55-4 If, instead of cash, holders of the shares underlying the contract receive other forms of consideration (for example, debt), the counterparty also must receive debt (cash in an amount equal to the **fair value** of the debt would not be considered the same form of consideration as debt).

55-5 Similarly, a change-in-control provision could specify that if all stockholders receive stock of an acquiring entity upon a change in control, the contract will be indexed to the shares of the purchaser (or issuer in a business combination accounted for as a pooling of interests) specified in the business combination agreement, without affecting classification of the contract.

55-6 In the event of nationalization, cash compensation would be the consideration for the expropriated assets and, as a result, a counterparty to the contract could receive only cash, as is the case for a holder of the stock underlying the contract. Because the contract counterparty would receive the same form of consideration as a stockholder, a contract provision requiring net cash settlement in the event of nationalization does not preclude equity classification of the contract.

There is an exception to the basic premise that instruments that require net-cash settlement do not meet the requirements of the equity classification guidance. Specifically, in some circumstances, an instrument does not fail the requirements of the equity classification guidance if the net-cash settlement requirement can only be triggered when all holders of the shares underlying the contract would also receive cash. [\[815-40-25-7 – 25-8, 55-2 – 55-6\]](#)

Following are the circumstances in which net-cash settlement does not cause an instrument to fail the requirements of the equity classification guidance.

- An instrument requires net-cash settlement upon the occurrence of an event that is within the sole control of the entity (see Question 8.11.10).

- An instrument requires net-cash settlement upon final liquidation of the entity. [815-40-25-9]
- An instrument requires net-cash settlement (or consideration other than shares) upon a change in control, as long as the holders of the contract's underlying shares receive the same form of consideration in the transaction causing the change in control. [815-40-55-3 – 55-4]
- An entity is nationalized and, as a result, both the holder of the contract and the holders of the contract's underlying shares would receive the same form of consideration (cash) for settlement. [815-40-55-6]
- This guidance does not apply to certain convertible debt instruments (see section 8.16.10).



Question 8.11.10

How does an entity determine whether an event is solely within its control?

Background: If an event that is not solely within the entity's control could require net-cash settlement, then a contract is generally required to be classified as a liability (with certain exceptions listed above). [815-40-25-8]

However, an instrument does not fail this requirement of the equity classification guidance if cash settlement could be required only by the occurrence of an event that is within the entity's control. Therefore, careful analysis of triggering events within a contract is needed to determine whether the event is within the entity's control.

Interpretive response: We believe an event can generally be considered within the entity's control if its occurrence or nonoccurrence depends only on a decision made by the entity's management or board of directors. In contrast, if a decision is made by the entity's shareholders, or a decision by management and/or the board of directors requires shareholder approval, the decision is not controlled by the entity. Further, we believe that a decision is not controlled by the entity if it is within the control of the entity's board of directors, but the board of directors is controlled by the holder(s) of the equity-linked financial instrument that benefits from that provision. [815-40-25-19]

See Question 7.3.100 for examples of events that are considered solely within the control of the entity, and those that are not.

The SEC staff has indicated that control needs to rest within an entity's governance structure (see below). The determination of whether an event is within an entity's control requires a clear understanding of the entity's governance structure, and of the details of the triggering events within the contract. For example, in a limited partnership, the general partner typically represents the governance structure. [2009 AICPA Conf]



Excerpt from SEC speech

In a typical corporate structure, the power to control the form of settlement might be expected to reside with the Board of Directors or executive management. However, there are a variety of governance structures in practice. For limited partnerships, the governance structure of the entity would often consist of the general partner, and one would usually expect cash versus share settlement decisions to reside with that partner in order for a decision to be within the company's control. In any case, in order for a settlement option to be under company control, one would generally expect that control would rest with the party or parties tasked with management or governance by the owners of the entity.

Brian W. Fields, Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB developments



Question 8.11.15

When can an instrument meet the equity classification requirements if it permits cash settlement when the holders of the underlying shares receive cash?

Interpretive response: Only when cash settlement is triggered by:

- the entity being nationalized; or
- an event that:
 - results in an accounting change in control of the entity;
 - is within the entity's control; or
 - is the final liquidation of the entity.

Net-cash settlement does not preclude equity classification only in specific situations as outlined in the introduction to this section. If an event that would trigger net-cash settlement is not one of those specific situations, the SEC staff has indicated that equity classification is precluded. For example, if an instrument (e.g. a warrant) contains a tender offer provision that triggers net-cash settlement of the instrument even if the tender offer does not result in a change in control, it would not meet the additional conditions for equity classification. [[SEC Statement \(4/12/21\)](#)]



Example 8.11.10

Classification of warrants with tender offer provision by issuer with two classes of voting common shares

ABC Corp has two classes of common shares outstanding: Class A issued to the public and Class B issued to the sponsors. Both classes have the same

voting rights (one vote per share) and dividend rights. ABC has 800 Class A and 200 Class B common shares outstanding.

ABC has outstanding warrants to purchase its Class A common shares. The warrants contain a provision whereby if a party(ies) that makes a tender offer owns more than 50% of the outstanding Class A common shares after completion of the tender offer, the warrant holders will be entitled to receive the same form of consideration received by the Class A common shareholders. For example, if the Class A common shareholders were to receive cash consideration in the tender offer, the warrant holders also would be entitled to receive cash. The occurrence of a tender offer is not in ABC's control.

The warrants permit cash settlement if the holders of the underlying shares receive cash, even if no change in control or nationalization occurs. For example, if a tender offer results in 55% of the Class A common shares being acquired for cash, the warrant holders would be entitled to receive cash. However, that transaction would not result in a change in control of ABC because only 44% of all ABC's common shares would have been acquired: $55\% \text{ of Class A common shares acquired} \times 800 \text{ Class A common shares outstanding} \div 1,000 \text{ total common shares outstanding}$.

Based on the above facts, a tender offer triggering net-cash settlement of the warrants may not result in a change in control of ABC, is not in ABC's control and is not a final liquidation or nationalization of ABC. Therefore, ABC is required to classify the warrants as a liability, even though the warrant holders would receive cash only if that is the same form of consideration received by the holders of the Class A common stock underlying the warrants in a tender offer transaction.



Question 8.11.20

Does an instrument that is puttable upon a fundamental transaction meet the requirements of the equity classification guidance?

Background: Some equity-linked financial instruments include provisions that require net-cash settlement (or give the holder the option of settlement) only upon the occurrence of an event that is within the entity's (which includes the entity's board of directors) control; see Question 8.11.10.

For example, an instrument may contain a feature that, on the occurrence of a fundamental transaction (which is defined in the agreement), gives the holder the option to put the warrant back to the entity at a price equal to the Black-Scholes value as of the date of the fundamental transaction. The provisions of the feature indicate that, if the fundamental transaction is within the entity's control (e.g. merger, sale of significant assets), the holder will receive that consideration in the form of cash. However, if the fundamental transaction is not within the entity's control (e.g. a tender offer), the consideration is in the form that is being offered and paid to holders of common stock in connection with the fundamental change.

Interpretive response: It depends on whether

- the event triggering the redemption option is within the entity's control; and if not
- the fundamental transaction results in an accounting change in control of the entity.

We believe that a provision such as the one described in the background typically does not cause an instrument to fail the requirements of the equity classification guidance. This is because the only way the issuer will be required to cash settle the instrument is if the fundamental transaction is triggered, which is within its control. When a fundamental transaction is not within the entity's control and results in a change in control of the entity, the entity is permitted to provide the holder with the same consideration as the holders of the underlying shares received in the fundamental transaction (see section 8.10).

However, in some situations, a fundamental transaction may not result in a change in control of the entity. In those situations, the SEC staff has indicated net-cash settlement would preclude equity classification, even if the instrument's holder receives the same form of consideration as the holders of the underlying shares (see Question 8.11.15). [[SEC Statement \(4/12/21\)](#)]



Question 8.11.30

Does an instrument that requires the entity to pay cash in lieu of fractional shares upon settlement fail the requirements of the equity classification guidance?

Background: Often a net-share settled equity-linked financial instrument will settle at an amount that requires the entity to deliver a portion of a share (or a fractional share) to the holder of the instrument.

For example, assume the same facts as Example 8.10.10 except that Issuer's share price is \$7 per share on the day the warrants are settled. If the warrants are net-share settled, Issuer would be required to deliver 42.9 shares to Holder.

Holder's gain on the settlement of the warrants is the difference between the fair value of the shares on the settlement date of \$700 (100 shares × \$7 per share) and the settlement amount of \$400 (100 shares × \$4 per share). The gain of \$300 equates to 42.9 shares (\$300 ÷ \$7 per share).

Under the terms of the contract, Issuer is required to pay cash to Holder for any partial shares due to Holder. In this case, Issuer delivers 42 shares and \$6.30 (\$7 share price times 0.9) to Holder.

Interpretive response: No. We believe a requirement for the issuer of an equity-linked financial instrument to pay cash in lieu of fractional shares upon settlement of the instrument does not cause the instrument to fail the requirements of the equity classification guidance.



Question 8.11.40

Does a warrant that requires the entity to pay stamp, transfer, government or similar taxes fail the requirements of the equity classification guidance?

Background: The terms of a warrant agreement may require the entity to reimburse the holder, in cash, certain costs associated with the issuance of the warrant, the shares of common stock upon exercise of the warrant or both. For example, the entity may be required to pay:

- any and all documentary, stamp duty or transfer taxes; or
- all expenses, taxes and other governmental charges related to the issuance or delivery of common shares upon exercise of the warrants.

The terms of the warrant agreement may be very specific or very broad in defining the costs that are or are not to be paid by the entity.

Questions may arise as to whether the payment by the entity of these costs would cause the instrument to fail the requirements of the equity classification guidance, specifically because if the instrument requires (or gives the holder an option to require) net-cash settlement, the requirements of the equity classification guidance are not met. [815-40-25-4]

Interpretive response: It depends. Whether such clauses cause an instrument to fail the requirements of the equity classification guidance depends on a legal analysis of what the entity is agreeing to pay.

Type of payment	Requirements failed?
The warrant agreement requires the entity to make cash payments to or on behalf of the holder for holder-specific taxes (e.g. WHT or personal income taxes) that the holder is required to pay to a taxing authority.	<p>Yes</p> Because the payments are for expenses of the warrant holder, payment by the entity is considered a cash settlement of the instrument. Further, the settlement amount would likely be considered to be adjusted for inputs that are inconsistent with the valuation of a fixed-for-fixed instrument that would fail the indexation guidance (see section 8.8.40).
The entity agrees to pay stamp duty, transfer, government or similar taxes, or fees that are normally required for the issuance of any warrant or any equity share in the jurisdiction of issuance.	<p>No</p> The arrangement could be considered a separate unit of account (similar to a registration payment arrangement; see Question 8.3.10) and accounted for separately under Topic 450 (contingencies).



Question 8.11.50

Must an instrument's holders be able to choose the form of consideration for the consideration to be the 'same' if the holders of the instrument's underlying shares can choose?

Background: Certain equity-linked instruments' terms provide for the possibility that the holders of the shares underlying the instrument may determine the form of consideration used in settlement upon a change in control – i.e. the holders of the underlying shares can choose from different forms of consideration. In that situation, the equity-linked instrument's terms require that its holders will receive the weighted average consideration (in form and amount) elected by the holders of the underlying shares. That is, the instrument's holders will not have a choice in the form of consideration they receive, although the holders of the underlying shares will.

Other equity-linked instruments' terms require the consideration received by the instruments' holders to be the highest cash value or the highest value available when the holders of the underlying shares have a choice of settlement options.

Interpretive response: No, we do not believe the instrument's holders must be able to choose the form of consideration for it to be considered the same as that received by the holders of the instrument's underlying shares.

Equity classification is not precluded if a change-in-control provision requires that counterparty to receive (or permits the counterparty to deliver upon settlement) the 'same form' of consideration as the holders of the shares underlying the contract. When the same form of consideration is received by the equity-linked instruments' holders on settlement as was received by the holders of the underlying shares, we believe it is acceptable to conclude that equity classification is not precluded. This is because the form of consideration is the same, even if the holders of the underlying shares were permitted to choose the form of consideration and the equity-linked instruments' holders were not.

8.12 The equity classification guidance – additional conditions

8.12.10 Overview



Excerpt from ASC 815-40

> Additional Conditions Necessary for Equity Classification

25-10 Because any contract provision that could require net cash settlement precludes accounting for a contract as equity of the entity (except for those circumstances in which the holders of the underlying shares would receive

cash, as discussed in paragraphs 815-40-25-8 through 25-9 and paragraphs 815-40-55-2 through 55-6), all of the following conditions must be met for a contract to be classified as equity:

- a. Subparagraph superseded by Accounting Standards Update No. 2020-06.
- b. Entity has sufficient authorized and unissued shares. The entity has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the derivative instrument could remain outstanding.
- c. Contract contains an explicit share limit. The contract contains an explicit limit on the number of shares to be delivered in a share settlement.
- d. No required cash payment (with the exception of penalty payments) if entity fails to timely file. There is no requirement to net cash settle the contract in the event the entity fails to make timely filings with the Securities and Exchange Commission (SEC).
- e. No cash-settled **top-off** or **make-whole provisions**. There are no cash settled top-off or make-whole provisions.
- f. Paragraphs 815-40-25-39 through 25-42 explain the application of these criteria to convertible debt and other hybrid instruments.

25-10A The following conditions are not required to be considered in an entity's evaluation of net cash settlement (that is, if any one of these provisions is in a contract [or the contract is silent on these points], they should not preclude equity classification, except as described below):

- a. Whether settlement is required in registered shares, unless the contract explicitly states that an entity must settle in cash if registered shares are unavailable. Requirements to deliver registered shares do not, by themselves, imply that an entity does not have the ability to deliver shares and, thus, do not require a contract that otherwise qualifies as equity to be classified as a liability.
- b. Whether counterparty rights rank higher than shareholder rights. If the provisions of the contract indicate that the counterparty has rights that rank higher than the rights of a shareholder of the stock underlying the contract, this provision does not preclude equity classification.
- c. Whether collateral is required. A provision requiring the entity to post collateral at any time for any reason does not preclude equity classification.

• • > Uneconomic Settlement Alternatives

25-18 If a settlement alternative includes a penalty that would be avoided by an entity under other settlement alternatives, the uneconomic settlement alternative shall be disregarded in classifying the contract.

If any of the additional conditions necessary for equity classification discussed in this section are not met, the entity may be forced to net-cash settle the equity-linked financial instrument. As discussed in section 8.10, net-cash settlement typically causes an instrument to fail the requirements of the equity classification guidance.

The following table summarizes the additional conditions necessary for equity classification. [815-40-25-10]

Condition	Description
#1. Entity has sufficient authorized and unissued shares	The entity has sufficient authorized and unissued shares to share-settle the instrument.
#2. Contract contains an explicit share limit	There is a limit on the number of shares the entity will be required to deliver upon settlement of the instrument.
#3. No required cash payments if the entity fails to timely file with the SEC	The entity is not required to make cash payments (other than penalty payments) to the holder of the instrument if it fails to timely file with the SEC.
#4. No cash-settled top-off or make-whole provisions	The provisions of the instrument do not include cash-settled top-off or make-whole provisions.

For some entities and/or instruments, the likelihood of any of these additional conditions not being met may be remote. However, these conditions must still be evaluated because if the occurrence of an event is outside of the entity's control, the probability of the event occurring is irrelevant when evaluating it unless the payment of cash is required only upon final liquidation of the entity. [815-40-25-9]

These additional conditions necessary for equity classification do not apply to certain convertible debt instruments discussed in section 8.16.10.



Question 8.12.10

What provisions are not considered when evaluating net-cash settlement?

Interpretive response: With the adoption of ASU 2020-06, the following contractual provisions are not considered in evaluating whether a contract requires net-cash settlement and therefore do not preclude an instrument from being classified as equity: [815-40-25-10A]

- settlement is required in registered shares (unless the contract explicitly states that an entity must settle in cash if registered shares are unavailable) (see Question 8.12.20);
- the counterparty rights rank higher than shareholder rights; or
- collateral is required. (see Question 8.12.30).

Although these provisions are not considered when evaluating whether the conditions in the equity classification guidance are met, an entity that applies the SEC's guidance on temporary equity considers these provisions when making that evaluation (see Question 7.2.91).



Question 8.12.20

What does an entity need to consider if a contract requires settlement in registered shares?

Background: ASU 2020-06 removed the additional condition in paragraph 815-40-25-10 that precluded equity classification for an instrument unless the contract contained an explicit provision permitting the issuer to settle in unregistered shares.

The FASB removed the unregistered shares condition (1) to align it with the registered shares guidance in Topic 718, and (2) because a requirement to settle in registered shares does not imply that an entity does not have the ability to settle in registered shares. Often the evaluation of an entity's ability to settle in unregistered shares involved complex legal and accounting analysis when the contracts included a provision that precluded cash settlement if the entity was not able to deliver registered shares. [ASU 2020-06.BC85-BC89]

Interpretive response: If the contractual terms in an agreement require the instrument to be settled in registered shares, the entity must determine if there is an explicit requirement in the agreement to cash-settle the instrument if registered shares are not available. However, an entity is not required to look beyond the contractual terms to determine whether there is an implicit requirement to cash settle when assessing equity classification. An explicit requirement in the contract to cash-settle the instrument when registered shares are unavailable precludes equity classification. [815-40-25-10A(a), ASU 2020-06.BC85]

In addition, when a contract meets the conditions for equity classification, an entity that applies the SEC's guidance on temporary equity considers a requirement to settle a contract in registered shares when making that evaluation (see Question 7.2.91).

Evaluation of collateral provisions in contracts

As discussed in Question 8.12.10, ASU 2020-06 removed the condition that precludes equity classification when a contract requires collateral to be posted. The FASB's reasoning is that transferring collateral under a contract is inconsistent with the concept of settlement because collateral may be returned and therefore should not preclude equity classification. [ASU 2020-06.BC90-BC92]



Question 8.12.30

Do master netting arrangements covering both equity- and nonequity-classified contracts preclude equity classification?

Background: Master netting arrangements are provisions often found in ISDA agreements. They allow instruments to be netted/offset against other instruments when determining the amount due in the case of default by either party to the agreement. In such an arrangement, an instrument that would

otherwise be classified as equity can be netted against an instrument that is not equity-classified.

Interpretive response: Yes. While paragraph 815-40-25-10A(c) states that a provision in an equity-linked instrument that requires the issuer to post collateral (which can be used to satisfy the contract through cash or other assets instead of shares) does not preclude equity classification, it does not specifically address master netting arrangements. If an issuer (or the counterparty) defaults on a contract that is subject to such a master netting arrangement, the issuer could be required to net settle a contract that is indexed to its own shares with another contract that is non-equity classified (such as an interest rate swap).

We believe that because the event of the issuer's own default (or the counterparty's default), however remote, is outside its own control, equity-linked instruments that are subject to a master netting arrangement with other non-equity contracts do not qualify for equity classification.

However, if the terms of an equity-linked instrument specifically exclude it from the netting requirements of the master netting arrangement, equity classification is not precluded.

Uneconomic settlement alternatives

A settlement alternative can be uneconomic to the issuer (e.g. because it includes a penalty or a settlement alternative that is significantly more costly), such that the entity would avoid the settlement alternative in favor of other settlement alternatives. The uneconomic settlement alternative can be disregarded in evaluating equity classification (see Example 8.12.10). [815-40-25-18]



Example 8.12.10

Uneconomic settlement alternatives in an equity-linked financial instrument

Issuer issues warrants that permit Holder to purchase 100 shares of its common stock for \$5 per share. The warrants have a 20-year term and are exercisable at any time.

The terms of the warrants give Issuer the option to either net-share or net-cash settle the warrants. However, if Issuer elects net-share settlement, it is required to provide Holder with a penalty of 1,000 additional shares.

Issuer concludes that the warrants meet the requirements of the indexation guidance and therefore proceeds to the equity classification guidance.

The basic premise of the equity classification guidance is that an instrument does not fail the equity classification conditions when the terms of the instrument allow Issuer to elect either cash or share settlement because Issuer has the ability to share-settle.

However, because the substance of this agreement is such that Issuer would avoid a significant penalty if it were to net-cash settle the warrants, it is

assumed that cash settlement is required. Therefore, the instrument fails the requirements of the equity classification guidance.

8.12.20 Additional Condition #1: Entity has sufficient authorized and unissued shares



Excerpt from ASC 815-40

- > Entity Has Sufficient Authorized and Unissued Shares

25-19 If an entity could be required to obtain shareholder approval to increase the entity's authorized shares to net share or physically settle a contract, share settlement is not controlled by the entity.

25-20 Accordingly, an entity shall evaluate whether a sufficient number of authorized and unissued shares exists at the classification assessment date to control settlement by delivering shares. In that evaluation, an entity shall compare both of the following amounts:

- a. The number of currently authorized but unissued shares, less the maximum number of shares that could be required to be delivered during the contract period under existing commitments, including any of the following:
 1. Outstanding convertible debt that is convertible during the contract period
 2. Outstanding stock options that are or will become exercisable during the contract period
 3. Other derivative financial instruments indexed to, and potentially settled in, an entity's own stock.
- b. The maximum number of shares that could be required to be delivered under share settlement (either net share or physical) of the contract.

25-21 When evaluating whether there are sufficient authorized and unissued shares available to settle a contract, an entity shall consider the maximum number of shares that could be required to be delivered under a registration payment arrangement to be an existing share commitment, regardless of whether the instrument being evaluated is subject to that registration payment arrangement.

25-22 If the amount in paragraph 815-40-25-20(a) exceeds the amount in paragraph 815-40-25-20(b) and the other conditions in this Subtopic are met, share settlement is within the control of the entity and the contract shall be classified as a permanent equity instrument. Otherwise, share settlement is not within the control of the entity and asset or liability classification is required.

25-23 For purposes of this calculation, if a contract permits both (a) net share and (b) physical settlement by delivery of shares at the entity's option (both alternatives permit equity classification if the other conditions in this Section

are met), the alternative that results in the lesser number of maximum shares shall be included in this calculation.

25-24 If a contract is classified as either an asset or a liability because the counterparty has the option to require settlement of the contract in cash, then the maximum number of shares that the counterparty could require to be delivered upon settlement of the contract (whether physical or net share) shall be assumed for purposes of this calculation.

For an equity-linked financial instrument to pass additional Condition #1, the entity must have sufficient authorized and unissued shares available to net-share or physically settle a contract. If the entity does not have sufficient authorized and unissued shares available, management will need to obtain shareholder approval (which is not within the entity's control) to authorize additional shares.

Additional Condition #1 must be met in order for an instrument to be equity-classified, regardless of whether the instrument permits the entity to net-cash settle it. [815-40-25-19]



Question 8.12.40

How does an entity account for an equity-linked financial instrument when it does not have sufficient authorized and unissued shares for settlement?

Interpretive response: If the entity does not have a sufficient number of authorized and unissued shares available to share-settle the instrument being analyzed, the entire instrument is liability-classified. However, if the terms of the instrument allow it to be settled with multiple methods simultaneously, the portion of the instrument for which sufficient authorized and unissued shares are available may be equity-classified (if it also meets the other requirements for equity classification), while the remainder is liability-classified.

For example, if an entity issues one warrant for 100 common shares, and upon exercise the entity is permitted to settle some of the warrant with shares and some with net cash, the portion of the instrument for which sufficient authorized and unissued shares are available may be equity-classified while the remainder would be liability-classified.



Question 8.12.50

How does an entity determine whether it has sufficient authorized and unissued shares for settlement?

Interpretive response: The determination of whether an entity has sufficient authorized and unissued shares available is made after considering all other commitments that may require the issuance of shares during the maximum

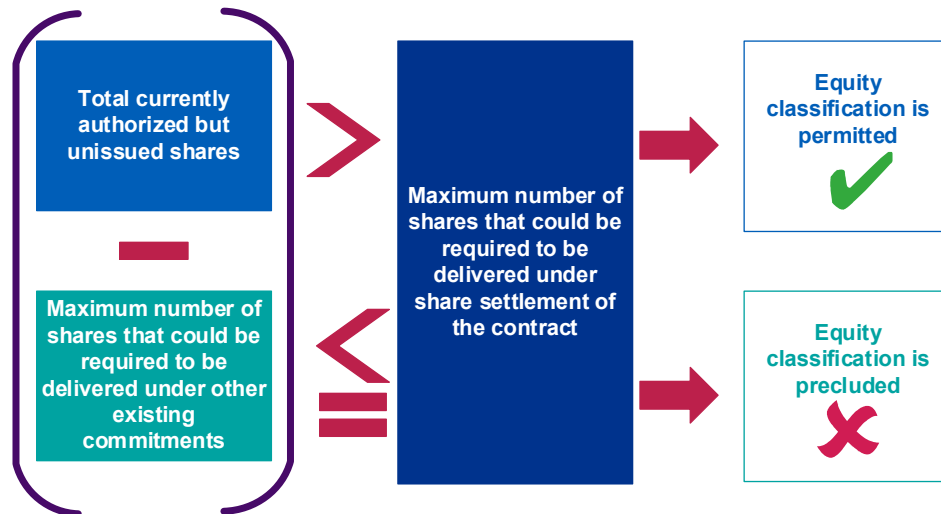
period that the contract could remain outstanding. This includes any instrument that either requires physical or net-share settlement, or gives the holder of the instrument the option of settlement method – this is regardless of whether the instrument is equity-classified or liability-classified.

This includes any the following types of commitments:

- contracts in the scope of Subtopic 815-40
- contracts in the scope of Topic 480
- share-based payment awards
- top-off or make-whole provisions included in outstanding instruments (see section 8.12.50)
- registration payment arrangements
- convertible preferred shares
- share-settled contingent consideration in a business combination.

The entity must also consider the maximum number of shares that could be required to be delivered under a registration payment arrangement to be an existing share commitment. This is required regardless of whether the instrument being evaluated is subject to that registration payment arrangement. Question 8.3.10 discusses registration payment arrangements. [815-40-25-21]

The entity then determines if it has sufficient authorized but unissued shares to share-settle the instrument being analyzed using the following formula. [815-40-25-20, 25-22]





Question 8.12.60

How does an entity determine the number of shares in its calculation of authorized and unissued shares if an instrument permits the issuer or holder to choose the settlement method?

Interpretive response:

Issuer has choice of settlement

When evaluating an instrument where the issuer has the choice of settlement, this calculation assumes the option that results in the fewest number of shares issued to settle. [815-40-25-23]

For example, a warrant may be settled, at the issuer's option, physically, net-cash or net-share. Because the issuer can elect the share settlement method (either physically or net shares), it includes the net-share settlement in the calculation. This is because it results in the fewest number of shares if it settled in shares.

Holder has choice of settlement

If the holder of the instrument has the choice of settlement, it is assumed that the option that results in the greatest number of shares will be used to settle. [815-40-25-24]

For example, an entity issues warrants to purchase 100 shares at \$5 per share. The warrants permit either gross share settlement, net-share settlement, or net-cash settlement at the option of the holder. Upon exercise, the holder of the warrants can elect to:

- purchase 100 shares for \$5 per share;
- net-share settle the contract. The maximum number of shares the entity will be required to issue to settle the warrant is capped at 100; so if the entity's share price is \$10,000 per share, it will have to issue 99.95 shares: $100 \times (\$10,000 - \$5) / \$10,000$; or
- receive net cash for the fair value of the warrants.

The entity assumes that 100 shares will be issued to settle the warrants.

Although the warrants are liability-classified (because the holder has the ability to net-cash settle the warrants), the potential maximum number of shares used to settle the warrants is considered in determining whether the entity's other equity-linked financial instruments pass additional Condition #1. [815-40-25-24]



Question 8.12.65

Is additional Condition #1 met if an equity-linked financial instrument's terms specify that the entity is not required to net-cash settle it even if there are insufficient authorized and unissued shares?

Interpretive response: Yes, if the instrument's terms do not permit its exercise if there are insufficient authorized and unissued shares. We believe that additional Condition #1 can be considered met if an equity-linked financial instrument's terms specify that it cannot be exercised and the entity would not be required to net-cash settle the instrument in the event it does not have sufficient authorized and unissued shares to settle it.

For example, Issuer's outstanding warrants specify that Issuer has no obligation to deliver any shares if it does not have sufficient authorized and unissued shares to settle an exercise and that under no circumstance is Issuer required to net-cash settle the warrants if there are insufficient shares. Issuer concludes that additional Condition #1 is met.




Question 8.12.70

How does an entity evaluate whether an instrument passes additional Condition #1 if the entity is required to issue shares upon the occurrence of a specified event?

Interpretive response: If a commitment includes a provision that would require the entity to issue shares upon the occurrence of a specified event, whether those shares are considered in the evaluation depends on whether the occurrence of the event is within the entity's control.

If an instrument requires the entity to issue shares if an event occurs that is within the entity's control, those additional shares are not considered. For example, any shares to be issued as a result of a dividend declaration, stock split or similar transaction would be excluded from the calculation of the maximum number of shares that could be required to be delivered under other existing commitments (assuming execution of the transaction is within the entity's control).

In contrast, if occurrence of the event that would require the entity to issue shares is not within the entity's control, the number of shares required to be issued on occurrence of that event is considered in determining whether the instrument passes additional Condition #1.

 **Question 8.12.80**
How does an entity evaluate whether an instrument passes additional Condition #1 if it has multiple equity-linked financial instruments?

Interpretive response: This evaluation is performed any time the entity issues new equity or equity-settled contracts (e.g. new stock options, convertible debt, common stock). This is because issuance of such instruments has an effect on the number of available authorized, but unissued shares.

Subtopic 815-40 does not provide guidance on whether a specific sequencing should be followed in this assessment. However, it provides the following examples of sequencing methods that an entity may elect for reclassification of contracts: [815-40-35-12]

- partial proportionate reclassification of all contracts (if partial settlement is permitted);
- reclassification of contracts with the earliest inception date or maturity date first;
- reclassification of contracts with the latest inception date or maturity date first.

We believe an entity should develop a sequencing policy for initial assessment of equity-linked financial instruments. We believe the following sequencing methods are acceptable.

Sequencing method	Description
First-in, first-out (FIFO)	Authorized but unissued shares used to satisfy instruments in chronological order beginning with the earliest issuance
Last-in, first-out (LIFO)	Authorized but unissued shares used to satisfy instruments in reverse chronological order beginning with the latest issuance
Earliest maturity date first	Authorized but unissued shares used to satisfy instruments with the earliest maturity date first
Latest maturity date first	Authorized but unissued shares used to satisfy instruments with the latest maturity date first

Other methods may be acceptable. The method used should be systematic, rational and consistently applied. For example, if an entity chooses a LIFO policy and then issues an instrument with no cap on the number of shares that may need to be issued under that instrument, it would have to reclassify all equity-linked financial instruments issued before that instrument from equity to liability. This is because under a LIFO policy this newly issued instrument is the first to be analyzed under additional Condition #1. Because the instrument has no cap on the number of shares that may need to be issued, the entity cannot conclude that any of its instruments pass additional Condition #1.



Question 8.12.90

Does a stock exchange's '20% rule' affect whether an equity-linked financial instrument subject to the rule meets additional Condition #1?

Background: The NYSE and the NASDAQ have certain shareholder approval rules in place to protect the investments of pre-existing shareholders. One such rule – the '20% rule' – requires an entity to obtain shareholder approval, in certain cases, to issue 20% or more of its outstanding common stock or voting power. To determine whether these rules apply to an instrument issued and whether shareholder approval is required at issuance (or settlement) of the instrument, an entity should consult with its lawyers.

Interpretive response: It depends. When evaluating additional Condition #2, an entity considers whether an instrument that is currently exercisable would be required to obtain shareholder approval before settling an instrument subject to the 20% rule. If so, additional Condition #2 is not met because settlement of the instrument in shares is not in the entity's control when shareholder approval is necessary to issue those additional shares (see section 8.12.20). However, if the requisite shareholder approval is obtained, the instrument would no longer be precluded from meeting additional Condition #2. Further, if the instrument is not exercisable before shareholder approval is obtained, the instrument would not be precluded from meeting additional Condition #2.

Additionally, instruments that would be subject to the 20% rule frequently include contractual limits on the number of shares issuable upon settlement to obviate the need to obtain shareholder approval – e.g. a contractual limit on issuing shares in excess of 19.99%. While these terms may result in additional Condition #2 being met, they may result in the instrument not meeting other aspects of the indexation or equity classification guidance.



Example 8.12.20

Warrant with a share cap

Issuer issues net-share settleable warrants that permit the holder to purchase 10 million shares of its common stock for \$10 per share. The warrants have a 20-year term and are exercisable at any time.

Scenario 1: Shares in excess of cap upon exercise are net-cash settled

The contract includes a provision that limits the number of shares that Issuer is required to deliver to 19.99% of the number of shares outstanding at the time of exercise. Any amount due to the holder in excess of that amount will be settled net-cash.

As explained in section 8.10.10, the warrants do not meet the requirements of the equity classification guidance because Issuer could be required to net-cash settle the warrants for the portion of shares in excess of 19.99% of its then-outstanding shares.

Scenario 2: Shares in excess of cap upon exercise are not issued or otherwise settled, but cap is removed upon shareholder approval

The contract includes a provision that limits the number of shares that Issuer is required to deliver to 19.99% of the number of shares outstanding at the time of exercise. The contract specifies that:

- shares in excess of the 19.99% cap will not be issued and the entity is not required to make any cash payment related to the excess shares;
- however, if shareholder approval is obtained, the 19.99% cap is removed.

The warrant's settlement amount depends on whether shareholder approval is obtained: the number of shares issuable under the warrant is limited to 19.99% of the shares outstanding at exercise unless shareholder approval is obtained. Because shareholder approval is not an explicit input used in the pricing of a fixed-for-fixed option contract or an implicit input or assumption used in a standard pricing model (see Question 8.8.30), the instrument fails the indexation guidance.

8.12.30 Additional Condition #2: Contract contains an explicit share limit



Excerpt from ASC 815-40

- > Contract Contains an Explicit Share Limit

25-26 For certain contracts, the number of shares that could be required to be delivered upon net share settlement is essentially indeterminate. If the number of shares that could be required to be delivered to net share settle the contract is indeterminate, an entity will be unable to conclude that it has sufficient available authorized and unissued shares and, therefore, net share settlement is not within the control of the entity.

25-27 If a contract limits or caps the number of shares to be delivered upon expiration of the contract to a fixed number, that fixed maximum number can be compared to the available authorized and unissued shares (the available number after considering the maximum number of shares that could be required to be delivered during the contract period under existing commitments as addressed in paragraph 815-40-25-20 and including top-off or make-whole provisions as discussed in paragraph 815-40-25-30) to determine if net share settlement is within the control of the entity. A contract termination trigger alone (for example, a provision that requires that the contract will be terminated and settled if the stock price falls below a specified price) does not satisfy this requirement because, in that circumstance, the maximum number of shares deliverable under the contract is not known with certainty unless there is a stated maximum number of shares.

25-28 This paragraph addresses a contract structure that caps the number of shares that must be delivered upon net share settlement but would also provide that any contract valued in excess of that capped amount may be delivered to the counterparty in cash or by delivery of shares (at the entity's

option) when authorized, unissued shares become available. The structure requires the entity to use its best efforts to authorize sufficient shares to satisfy the obligation. Under the structure, the number of shares specified in the cap is less than the entity's authorized, unissued shares less the number of shares that are part of other commitments (see paragraph 815-40-25-20). Use of the entity's best efforts to obtain sufficient authorized shares to settle the contract is within the entity's control. If the contract provides that the number of shares required to settle the excess obligation is fixed on the date that net share settlement of the contract occurs, the excess shares need not be considered when determining whether the entity has sufficient, authorized, unissued shares to net share settle the contract pursuant to paragraph 815-40-25-20. However, the contract may provide that the number of shares that must be delivered to settle the excess obligation is equal to a dollar amount that is fixed on the date of net share settlement (which may or may not increase based on a stated interest rate on the obligation) and that the number of shares to be delivered will be based on the market value of the stock at the date the excess amount is settled. In that case, the excess obligation represents stock-settled debt and shall preclude equity classification of the contract (or, if partial net share settlement is permitted under the contract pursuant to paragraph 815-40-35-11, precludes equity classification of the portion represented by the excess obligation).

If an entity is not able to determine the number of shares that will be required to settle an equity-linked financial instrument, it is unable to conclude that it has sufficient available authorized and unissued shares. Because the maximum number of shares that could be required to be delivered upon settlement of such an instrument is unknown, net-share settlement is not in the entity's control and therefore the instrument fails the requirements of the equity classification guidance. See, however, Question 8.12.65. [815-40-25-26]

To avoid this restriction, a contract may have an explicit share limit or the entity may be able to implicitly determine a share limit.



Question 8.12.100

How does an explicit or implicit share limit affect additional Condition #2?

Background: Many equity-linked financial instruments contain explicit share limits. For example:

- a \$1,000 convertible debt instrument that, on conversion, allows the holder of the instrument to receive either 10 shares of common stock or cash in the amount of the value of 10 shares of common stock, at the option of issuer.
- a forward sale contract that obligates the issuer to sell 200 shares of its common stock for \$20 per share at a certain time.

While some instruments may not explicitly state their share limits, the number can be derived implicitly. For example, an entity issues warrants that require net-share settlement. Upon exercise, the holder is entitled to 100 shares for \$5

per share. The maximum number of shares that entity will be required to issue to net-share settle the warrant is capped at 100, which requires the entity's share price to be around \$10 million per share: $100 \times (\$10 \text{ million} - \$5) / \$10 \text{ million}$).

Interpretive response: Even if an instrument's share limit can be determined (either explicitly or implicitly), the terms of the contract must be analyzed to identify any provisions that adjust the number of shares to be delivered on settlement upon the occurrence of a specified event.

If a contract has a provision that increases the number of shares to be delivered upon the occurrence of an event that is within the control of the entity, the adjustment can be disregarded and the entity can conclude that the instrument has a share limit.

In contrast, if the occurrence of that event is outside the entity's control (regardless of the likelihood of the event occurring), a share limit cannot be determined. In such cases, when determining if the instrument is eligible for equity classification, the entity has to consider whether the event causes the instrument to be settled and whether the holders of the underlying shares receive the same form of consideration (see Section 8.10).



Example 8.12.30

Equity-linked financial instrument with no share limit

Issuer issues convertible debt instruments, each with a par value of \$1,000 that, on conversion, entitle Holder to 10 shares of common stock. They also entitle Holder to a number of additional shares as determined by dividing a fixed monetary value (which starts at \$500 and declines by fixed increments over the debt term) by the conversion date per share fair value of Issuer's common stock.

The maximum number of common shares that could be required to be issued on conversion is theoretically unlimited. For instance, if Issuer's share price were to decline to \$0.01 per share shortly after issuance, Issuer would be required to deliver 50,010 shares of common stock per bond. This is calculated as the 10 shares the holder is automatically entitled to under the terms of the instrument, plus 50,000 additional: $\$500 \div \0.01 per share . For any decline in share price below \$0.01, Issuer has to issue more shares.

Therefore, for purposes of evaluating whether the embedded conversion option meets the requirements of the equity classification guidance of Subtopic 815-40, the criterion that the contract contains an explicit limit on the number of shares to be delivered in a share settlement is not met. Therefore, the conversion option is separated from the instrument and treated as a derivative under Subtopic 815-10.

Further, the existence of an instrument that may require settlement in an uncapped number of shares may prevent Issuer from asserting that it has the ability to settle its other equity contracts in shares – i.e. because the uncapped contract may use all available shares before exercise of the other instruments.

However, this may be avoidable if Issuer's policy for sequencing these instruments (when analyzing whether it has sufficient authorized and unissued shares) allows the instrument without a share limit to be analyzed last (see Question 8.12.60).



Question 8.12.110

How does a provision obligating an entity to use its best efforts to authorize sufficient shares for settlement affect additional Condition #2?

Background: The terms of an instrument will often establish a maximum number of shares that the entity could be required to deliver upon exercise. In that case, this maximum number must be used when determining if the entity has sufficient authorized and unissued shares available to settle the instrument (see section 8.12.20). [815-40-25-27]

Some instruments are structured in a way that caps the number of shares that are required to be delivered on net-share settlement, but also include provisions that compensate the holder if the instrument is valued in excess of that capped amount. These instruments allow the entity to deliver either cash or shares (once authorized, unissued shares become available) equal to the value above the capped amount. They require the entity to use its 'best efforts' to authorize sufficient shares to satisfy this obligation. [815-40-25-28]

Interpretive response: The terms of these types of instruments only require the entity to use its 'best efforts' to authorize sufficient shares to satisfy the additional obligation, and use of its best efforts is within the entity's control.

Therefore, these instruments meet the equity-classification condition that the number of shares required to settle the excess obligation is fixed on the date that the contract is net-share settled. Further, only the maximum number of shares that could be required up to the cap are considered when determining whether sufficient authorized, unissued shares are available.

The result is different if the amount of the excess obligation is fixed on the net-share settlement date, but the number of shares to be issued is based on the fair value of the shares on the date that the excess obligation is settled. In that case, the excess obligation is considered stock-settled debt, which precludes equity classification for the entire contract or for the portion that represents the excess obligation. [815-40-25-28]



Example 8.12.40

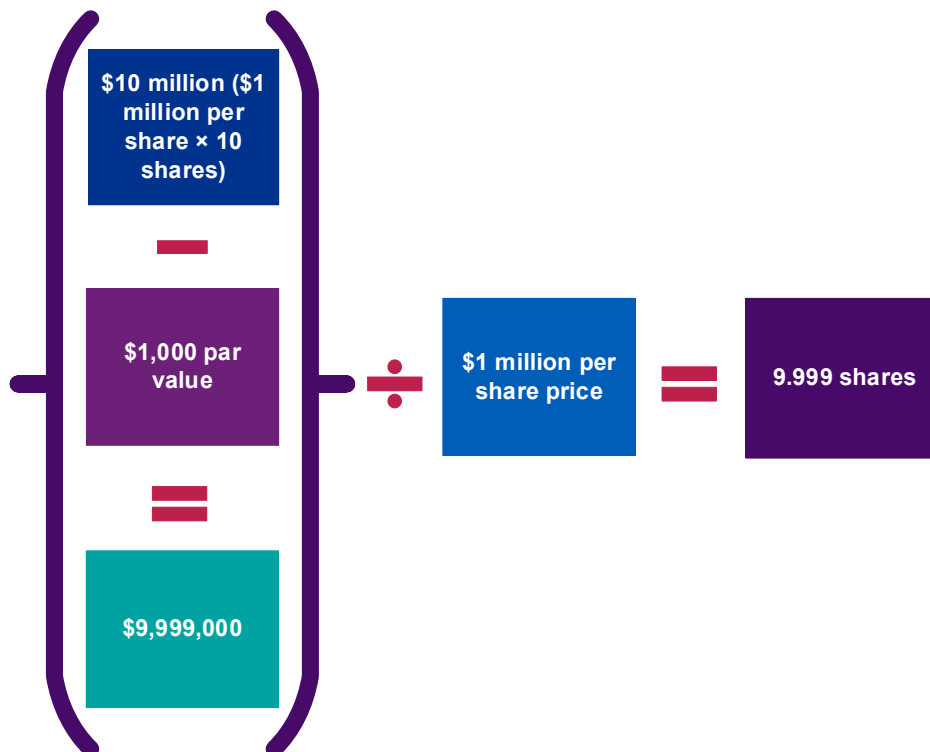
Equity-linked financial instrument with an explicit share limit

Issuer issues a convertible debt instrument with a par value of \$1,000 that, on conversion, entitles Holder to proceeds equal to the then-current fair value of 10 shares of common stock – i.e. \$100 effective conversion price.

On conversion, Issuer must satisfy the principal amount of the debt obligation in cash and may satisfy the conversion spread (the excess conversion value over the debt principal amount) in either cash or shares.

The number of shares issued on conversion is not fixed – i.e. the principal amount of the instrument is settled in cash and the conversion spread can be settled net-cash or net-share at the option of Issuer. As a result, this is not a type of convertible debt instrument discussed in section 8.16.10 that is exempt from meeting the additional conditions. Therefore, all of the requirements of Subtopic 815-40 apply – including additional Condition #2 – when Issuer is evaluating whether the embedded conversion option qualifies for the own equity scope exception from derivative accounting.

Although the number of shares issued on conversion of the debt instrument in this example is not fixed, 10 shares is the maximum number that could be required to be issued on conversion, regardless of the share price. For instance, if Issuer's share price is \$1 million per share at the conversion date and the principal amount of the debt is \$1,000, Issuer would be required to deliver \$1,000 cash and settle the remaining \$9.999 million conversion spread by delivering 9.999 shares of common stock per bond, which is calculated as follows.



Therefore, additional Condition #2 is met. However, Issuer must evaluate the remaining criteria in the equity classification guidance to determine whether the embedded conversion option meets the own equity scope exception from derivative accounting.



Question 8.12.120

How does an entity evaluate an equity-linked financial instrument that has multiple share caps?

Interpretive response: Subtopic 815-40 requires an instrument that contains a share cap to be evaluated assuming the capped maximum number of shares that could be delivered at settlement. [815-40-25-27]

If an instrument contains more than one cap, the maximum number of shares that could be delivered in every possible scenario is determined first. Then, the maximum number of shares that could be delivered at settlement is the maximum of all of the scenarios.

8.12.40 Additional Condition #3: No required cash payments if the entity fails to timely file with the SEC



Excerpt from ASC 815-40

- > No Required Cash Payment if Entity Fails to Timely File

25-29 The ability to make timely SEC filings is not within the control of the entity. Accordingly, if a contract permits share settlement but requires net cash settlement in the event that the entity does not make timely filings with the SEC, that contract shall be classified as an asset or a liability.

Additional Condition #3 is triggered if an equity-linked financial instrument permits the entity to share settle upon exercise, but requires net-cash settlement if the entity does not make timely filings with the SEC. If this is the case, the instrument does not meet the requirements of the equity classification guidance and is classified as an asset or a liability. This is because the timely filing of reports with the SEC is not entirely within the entity's control – e.g. the entity's auditors or other third parties may delay filing. The improbability of such an event occurring is not relevant. Therefore, if the terms of an instrument include such a settlement provision, the instrument fails the requirements of the equity classification guidance. [815-40-25-9, 25-29]



Question 8.12.130

Does an instrument fail additional Condition #3 if the entity must make a penalty payment if it fails to timely file with the SEC?

Background: Some equity-linked financial instruments require net-cash settlement of the contracts if the entity fails to make timely filings with the SEC. Others do not require net-cash settlement in this circumstance, but

instead require the entity to provide the holder of the instrument with a penalty payment that does not settle the equity-linked financial instrument.

Interpretive response: No. The existence of a provision requiring payment of a penalty if the entity fails to make timely filings with the SEC does not cause an instrument to fail additional Condition #3. However, if the penalty payment is in addition to a requirement to net-cash settle the instrument, equity classification is precluded. [815-40-25-10(d)]

For example, some convertible debt instruments may require additional interest payments if the entity fails to timely file with the SEC. Such payments do not necessarily cause the conversion option to fail the requirements of the equity classification guidance.

8.12.50 Additional Condition #4: No cash-settled top-off or make-whole provisions



Excerpt from ASC 815-40

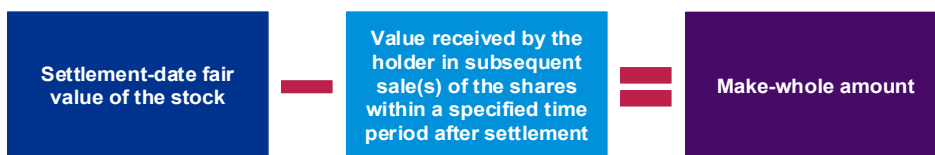
- > No Cash-Settled Top-Off or Make-Whole Provision

25-30 A top-off or make-whole provision would not preclude equity classification if both of the following conditions exist:

- a. The provision can be net share settled.
- b. The maximum number of shares that could be required to be delivered under the contract (including any top-off or make-whole provisions) is both:
 1. Fixed
 2. Less than the number of available authorized shares (authorized and unissued shares less the maximum number of shares that could be required to be delivered during the contract period under existing commitments as discussed in paragraph 815-40-25-20).

If those conditions are not met, equity classification is precluded.

Additional Condition #4 is triggered if an equity-indexed financial instrument contains a 'top-off' or 'make-whole' provision. These provisions require the entity to make a cash payment to the holder if the shares delivered upon settlement are subsequently sold by the holder and the proceeds are insufficient to provide the holder with full return of the amount due. As shown in the diagram, make-whole provisions are intended to reimburse the holder of the instrument for losses it incurs, or to transfer to the entity gains that the holder recognizes. [815-40 Glossary]



If an instrument contains such a provision, it would generally fail additional Condition #4 unless all of the below criteria are met: [815-40-25-30]

- the provision can be net-share settled (see section 8.10);
- the contract contains an explicit share limit – i.e. the maximum number of shares required under the contract, including any top-off or make-whole provision is fixed, which means that additional Condition #2 is met (see section 8.12.30); and
- the entity has sufficient authorized and unissued shares to share-settle the contract – i.e. additional Condition #1 is met (see section 8.12.20).



Question 8.12.140

What is the difference between a make-whole provision and 'make-whole shares'?

Interpretive response: There is a key difference between a make-whole provision and 'make-whole shares' referred to in Example 19 of Subtopic 815-40 (see section 8.8.60).

The purpose of the make-whole shares referred to in Example 19 is to neutralize the effect on the settlement amount of the convertible debt instrument if the entity is acquired for cash during the term of the instrument – an event which may have an adverse effect on the value of the convertible debt. Example 19 concludes that such a provision does not cause the conversion feature in the instrument to fail the requirements of the equity classification guidance.

The purpose of a make-whole provision discussed in additional Condition #4 is to compensate the holder of an instrument for the difference between the fair value of the entity's stock when the instrument was settled, and the fair value of the stock when the holder subsequently sells the stock. Such a provision results in failure of the requirements of equity classification guidance unless the above criteria are met.



Example 8.12.50

Make-whole provision in an equity-linked financial instrument

Issuer issues warrants on July 15, Year 1 that permit Holder to purchase 20 shares of its common stock for \$25 per share.

If, within 30 days after exercise, Holder is unable to sell the shares for at least their exercise-date fair value, Issuer must reimburse Holder for the difference. The reimbursement can be in cash or additional shares (limited to 20 shares), at Issuer's option. Issuer has enough authorized but unissued shares to share-settle the warrants.

This provision is a make-whole provision because it requires Issuer to reimburse Holder for an amount calculated as the difference between the settlement-date

fair value and the amount Holder receives in subsequent sale(s) of the shares within a specified period.

Equity classification is not precluded (assuming the instrument meets all of the other requirements of the equity classification guidance) because:

- Holder is given the option to either net-cash or net-share settle the instrument;
- the maximum number of shares Issuer could be required to deliver under the contract is capped (40 shares); and
- Issuer has enough authorized but unissued shares to share-settle the warrants.



Question 8.12.150#

Does the existence of a 'buy-in' provision cause an instrument to fail the requirements of the equity classification guidance?

Background: Certain equity-linked financial instruments contain a provision that contingently obligates the entity to pay a cash penalty if:

- the entity (or its transfer agent) fails to deliver the underlying shares upon the holder's exercise or conversion; and
- the holder has entered into an open-market transaction (i.e. short sold the shares before delivery by the entity/transfer agent) that requires it to purchase additional amounts of the entity's shares to cover the transaction as a result of this failure.

Such a provision is referred to as a 'buy-in' provision.

For example, Holder exercises a warrant to purchase 1,000 shares of Issuer's stock at a strike price of \$5 per share. Concurrently, Holder initiates a short sale of the shares at the current market price of \$10 per share for total proceeds of \$10,000.

Issuer fails to deliver the underlying shares to Holder; therefore, Holder must purchase shares in the market to cover its short sale. Because the market price for Issuer's stock has increased from the date of the short sale, Holder pays \$11,000 for 1,000 shares (\$1,000 more than the proceeds from the short sale). A buy-in provision would require Issuer to pay Holder \$1,000.

Interpretive response: Generally, no. The existence of a buy-in provision does not cause an equity-linked financial instrument to fail the requirements of the equity classification guidance. The analysis depends on whether the issuer controls the actions that would cause the buy-in provision to become effective. That is, whether the issuer has the ability to deliver shares in a timely manner upon the exercise of an equity-linked instrument.

Generally, a buy-in provision in an equity-linked financial instrument permits the holder to demand a cash payment from the issuer in an amount equal to the loss the holder sustained due to delayed receipt of shares upon exercising the instrument. Generally, the issuer does not have the right to settle the buy-in provision in shares and must provide the holder cash for such loss.

However, typically the issuer of the equity-linked financial instrument has the ability to prevent the scenarios for which such payments in cash would be required (i.e. the issuer usually has the ability to ensure timely share delivery when settling an equity-linked instrument).

As described in Question 8.11.15, equity classification may not be precluded in certain circumstances, including when cash settlement is in the entity's control. This requires the entity to determine whether the actions triggering the buy-in provision are in its control. Depending on the specific facts of the arrangement, the entity may determine that settlement of the buy-in provision in cash is in its control because the terms of the buy-in arrangement are indicative of the transfer agent acting as its agent and, therefore, it controls the actions triggering the buy-in provision and cash settlement.

Many issuers rely on a transfer agent to distribute shares to the counterparty upon exercise. Sometimes obligations for buy-in payments arise only if the issuer does not direct the transfer agent to execute the share transfer promptly. In these cases, the issuer can avoid these payments (i.e. prevent default) as long as it maintains enough authorized and unissued shares to fulfill the contract. In other scenarios, the issuer must make payments if the transfer agent does not deliver the shares timely. Because the transfer agent acts on behalf of the issuer in delivering shares under the contract, typically there are controls in place to ensure the transfer agent adheres to the issuer's instructions. As long as the period set for timely delivery is reasonable, it is reasonable to conclude that even though the transfer agent is a third party, it acts under the direction and as an extension of the issuer. Therefore, the issuer is viewed as having the ability to prevent these payments, and such payment provisions do not affect the classification of the equity-linked instrument.

While this provision may not preclude equity classification, the issuer assesses the provision (including when an exercise notification occurs) to determine if any contingent obligation under Topic 450 must be recognized for potential delays in issuing shares.

8.13 Initial and subsequent classification and measurement



Excerpt from ASC 815-40

> Evaluating Whether an Instrument or Embedded Feature Is Considered Indexed to an Entity's Own Stock

- > Instruments Classified as Liabilities or Assets

15-8A If the instrument does not meet the criteria to be considered indexed to an entity's own stock as described in paragraphs 815-40-15-5 through 15-8, it shall be classified as a liability or an asset. See paragraph 815-40-35-4 for subsequent measurement guidance for those instruments. See paragraph 815-40-15-9 for guidance on the interaction with this Subtopic and Subtopics 815-10 and 815-15 for derivative instruments and embedded derivatives.

25-5 Paragraph 815-20-55-33 explains that **derivative instruments** that are indexed to an entity's own stock and recorded as assets or liabilities can be hedging instruments.

30-1 All contracts within the scope of this Subtopic shall be initially measured at **fair value**.

> Overall

35-1 All contracts shall be subsequently accounted for based on the current classification and the assumed or required settlement method in Section 815-40-15 or Section 815-40-25 as follows.

• > Equity Instruments – Permanent Equity

35-2 Contracts that are initially classified as equity under Section 815-40-25 shall be accounted for in permanent equity as long as those contracts continue to be classified as equity. Subsequent changes in **fair value** shall not be recognized as long as the contracts continue to be classified as equity. Both of the following shall be reported in permanent equity:

- a. Contracts that require that the entity deliver shares as part of a **physical settlement** or a **net share settlement**
- b. Contracts that give the entity a choice of either of the following
 1. **Net cash settlement** or settlement in shares (including net share settlement and physical settlement that requires that the entity deliver shares)
 2. Either net share settlement or physical settlement that requires that the entity deliver cash.

• > Assets or Liabilities

35-4 All other contracts classified as assets or liabilities under Section 815-40-25 or paragraph 815-40-15-8A shall be measured subsequently at fair value, with changes in fair value reported in earnings and disclosed in the financial statements as long as the contracts remain classified as assets or liabilities (see paragraph 815-40-50-1).

> Settlement Assumptions

35-5 Net share settlement should be assumed for contracts that are classified under Section 815-40-25 as equity instruments that provide the entity with a choice of either of the following:

- a. Net share settlement
- b. Physical settlement that may require that the entity deliver cash.

35-6 Physical settlement should be assumed for contracts that are classified under Section 815-40-25 as equity instruments that provide the counterparty with a choice of either of the following:

- a. Net share settlement
- b. Physical settlement that may require that the entity deliver cash.

8.13.10 Overview

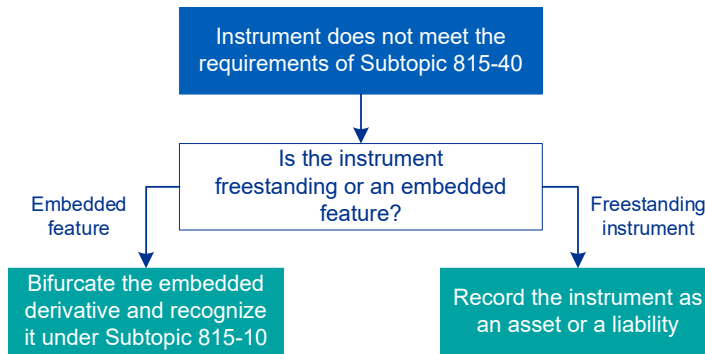
Generally, if an equity-linked financial instrument meets the requirements of both the indexation guidance and the equity classification guidance, it is classified as equity (or as discussed in Question 8.12.10 and section 8.1, as temporary equity). If these requirements are not met, it is classified as an asset or a liability. However, there are some nuances to this general rule depending on the type of instrument and whether it is a freestanding instrument or an embedded feature.

Section 8.13.20 explains the subsequent classification and measurement provisions when Subtopic 815-40's indexation and equity classification requirements are not met. Section 8.13.30 explains the subsequent classification and measurement provisions when they are met.

Regardless of classification, instruments in the scope of Subtopic 815-40 are measured initially at fair value. However, there may be some exceptions to the initial measurement requirement – see Question 8.13.50. [815-40-30-1]

8.13.20 When the requirements of Subtopic 815-40 are not met

The following decision tree illustrates the requirements when an instrument does not meet the requirements of Subtopic 815-40.



Question 8.13.10
How is an embedded feature accounted for when it does not meet the requirements of Subtopic 815-40?

Interpretive response: If an embedded feature does not meet the requirements of Subtopic 815-40, it does not qualify for the own equity scope exception from derivative accounting. As a result, the embedded feature is bifurcated from its host contract and separately accounted for as a derivative – i.e. as an asset or a liability, and initially and subsequently measured at fair value. [815-10-15-74(a), 25-1, 30-1, 35-1]

For in-depth discussion about accounting for derivative instruments, see chapter 5 of KPMG Handbook, [Derivatives and hedging](#).

Question 8.13.20
How is a freestanding instrument accounted for when it does not meet the requirements of Subtopic 815-40?

Interpretive response: If a freestanding instrument does not meet the requirements of Subtopic 815-40, it is initially measured at fair value and classified as a liability or, in some cases, as an asset.

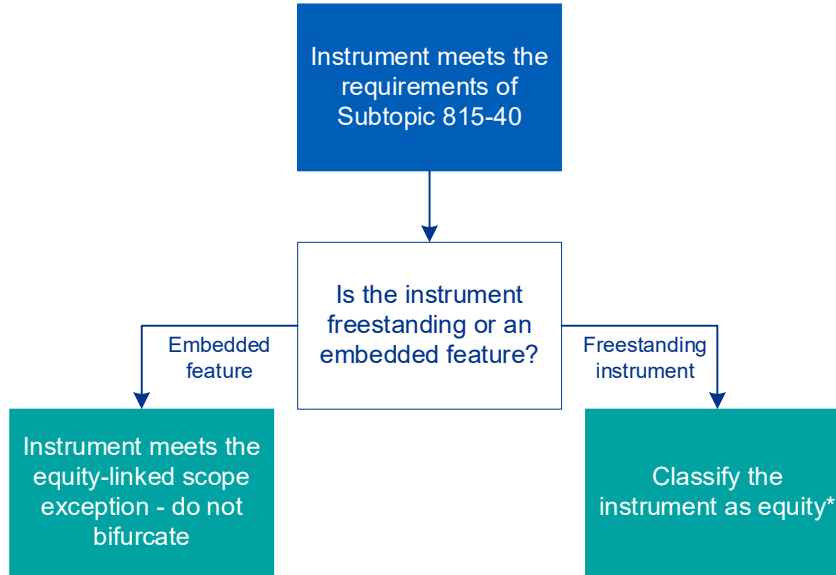
The following table summarizes the subsequent accounting requirements of freestanding instruments that do not meet the requirements of Subtopic 815-40.

Type of instrument	Subsequent accounting
Freestanding instrument that is not a derivative	<p>The instrument is classified as a liability (or an asset). [815-40-15-8A]</p> <p>The instrument is subsequently measured at fair value with changes in fair value recognized in earnings as long as it continues to be classified as an asset or a liability. Section 8.14 discusses reclassification. [815-40-35-1, 35-4]</p>
Freestanding instrument that is a derivative	<p>The instrument is accounted for as a derivative. Therefore, it is classified as a liability (or asset) and measured at fair value with subsequent changes in fair value recognized in earnings as long as it continues to not meet the requirements of Subtopic 815-40. Section 8.14 discusses reclassification.</p> <p>The instrument can be designated in a hedging relationship if all the criteria for hedge accounting are met. [815-40-25-5]</p> <p>The disclosure requirements of Subtopic 815-10 for derivative instruments also apply.</p>

For in-depth discussion about accounting for derivative instruments, see chapter 5 of KPMG Handbook, [Derivatives and hedging](#).

8.13.30 When the requirements of Subtopic 815-40 are met

This following decision tree illustrates the requirements when an instrument meets the requirements of Subtopic 815-40.



*If the entity applies the SEC's guidance on temporary equity, see section 8.1 and Question 8.12.10 for further considerations concerning the instrument's classification.

Question 8.13.30
How is an equity-classified embedded feature accounted for when it meets the requirements of Subtopic 815-40?

Interpretive response: If an embedded feature meets the requirements of Subtopic 815-40, it qualifies for the own equity scope exception from derivative accounting. As a result, the embedded feature is not bifurcated under Subtopic 815-10.

If the embedded feature is included in a convertible debt instrument or a liability-classified convertible preferred share, additional analysis is required to determine whether the substantial premium model applies. See section 10.4 for additional guidance.

Question 8.13.40
How is a freestanding instrument accounted for when it meets the requirements of Subtopic 815-40?

Interpretive response: If a freestanding instrument meets the requirements of Subtopic 815-40, it is generally classified as equity and initially measured at fair value. As long as the instrument continues to be classified as equity, subsequent changes in fair value are not recognized. Section 8.14 discusses the reclassification of instruments. [815-40-30-1, 35-1 – 35-2]

If an equity-classified instrument was issued by an SEC registrant (regardless of whether it is freestanding or embedded), the temporary equity guidance must also be analyzed (see chapter 7). It is unclear whether an entity that is determining whether to classify an instrument in temporary equity should continue to consider the conditions for equity classification in Subtopic 815-40 that were eliminated under ASU 2020-06; see Observation in section 7.1.



Question 8.13.50

How is a freestanding equity-classified instrument accounted for if it was issued with other instruments as part of a single transaction?

Background: Entities often enter into transactions that include two or more freestanding instruments. For example, a convertible debt instrument might be issued with a detachable warrant or a put option. Transactions such as these generally result in multiple freestanding instruments that are separately analyzed under applicable US GAAP.

Interpretive response: If the freestanding instrument was issued with other instruments as part of a single transaction, the total proceeds must be allocated among the instruments included in the transaction. The allocation method will depend on the initial and subsequent measurement requirements of the instruments. Questions 3.3.20 and 3.3.30 discuss the methods for allocating proceeds.

8.13.40 Modifications or exchanges of freestanding equity-classified written call options



Excerpt from ASC 815-40

> Overall

- > Equity Instruments – Permanent Equity

35-3 See paragraphs 815-40-35-14 through 35-18 for guidance on an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options that remain equity classified after modification or exchange.

> Issuer's Accounting for Modifications or Exchanges of Freestanding Equity-Classified Written Call Options

35-14 The guidance in paragraphs 815-40-35-15 through 35-18 applies to an issuer's accounting for a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option (for example, a warrant) that remains equity classified in accordance with this Subtopic after the modification or exchange and is not within the scope of another Topic. An entity shall account for the effects of a modification or an exchange in accordance with paragraphs 815-40-35-15 through 35-18. The disclosure

requirements in paragraphs 815-40-50-5 through 50-6 and 505-10-50-3 shall apply to a modification or an exchange of a freestanding equity-classified written call option. The guidance in paragraphs 815-40-35-16 through 35-17 does not apply to freestanding equity-classified written call options that are modified or exchanged to compensate grantees in a **share-based payment arrangement**. An entity shall recognize the effect of such modifications of freestanding equity-classified written call options by applying the requirements in Topic 718; however, classification of the instrument will remain subject to the requirements in this Subtopic.

35-15 An entity shall consider the circumstances of the modification or exchange of a freestanding equity-classified written call option to determine whether the modification or exchange is related to a financing or other arrangement or a multiple-element arrangement (for example, an arrangement involving both debt financing and equity financing). In making that determination, an entity shall consider all of the terms and conditions of the modification or exchange, other **transactions** entered into contemporaneously or in contemplation of the modification or exchange, other rights and privileges obtained or obligations incurred (including services) as a result of the modification or exchange, and the overall economic effects of the modification or exchange. If the modification or exchange is not within the scope of another Topic, an entity shall apply the guidance in paragraphs 815-40-35-16 through 35-18.

35-16 An entity shall treat a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option as an exchange of the original instrument for a new instrument. In substance, the entity repurchases the original instrument by issuing a new instrument. For transactions recognized in accordance with paragraph 815-40-35-17(c), the effect of a modification or an exchange shall be measured as the difference between the **fair value** of the modified or exchanged instrument and the fair value of that instrument immediately before it is modified or exchanged. For all other transactions recognized in accordance with paragraph 815-40-35-17, the effect of a modification or an exchange shall be measured as the excess, if any, of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before it is modified or exchanged. In a multiple-element transaction, the total effect of the modification or exchange shall be allocated to the respective elements in the transaction.

35-17 An entity shall recognize the effect of a modification or an exchange (calculated in accordance with paragraph 815-40-35-16) in the same manner as if cash had been paid as consideration, as follows:

- a. Equity issuance. An entity shall recognize the effect of a modification or an exchange that is directly attributable to a proposed or actual equity offering as an equity issuance cost. For additional guidance see SAB Topic 5.A, Expenses of Offering (paragraph 340-10-S99-1)
- b. Debt origination. An entity shall recognize the effect of a modification or an exchange that is a part of or directly related to an issuance of a debt instrument as a debt discount or debt issuance cost in accordance with the guidance in Topic 835 on interest
- c. Debt modification. An entity shall recognize the effect of a modification or an exchange that is a part of or directly related to a modification or an exchange of an existing debt instrument in accordance with the guidance

in Subtopic 470-50 on debt modifications and extinguishments and Subtopic 470-60 on troubled debt restructurings by debtors

- d. Other. An entity shall recognize the effect of a modification or an exchange that is not related to a financing transaction in (a) through (c) and is not within the scope of any other Topics (such as Topic 718) as a dividend. Additionally, for an entity that presents earnings per share (EPS) in accordance with Topic 260, that effect shall be treated as a reduction of income available to common stockholders in **basic earnings per share** in accordance with the guidance in paragraph 260-10-45-15.

35-18 Example 22 (see paragraphs 815-40-55-49 through 55-52) illustrates the application of the guidance in paragraphs 815-40-35-14 through 35-17.

This section provides guidance about how to account for certain modifications or exchanges of freestanding equity-classified written call options. Those modifications or exchanges are treated as an exchange of the original instrument for a new instrument. How the effect of a modification or exchange is measured and recognized depends on whether it is related to: [\[815-40-35-14, 35-16 to 35-17\]](#)

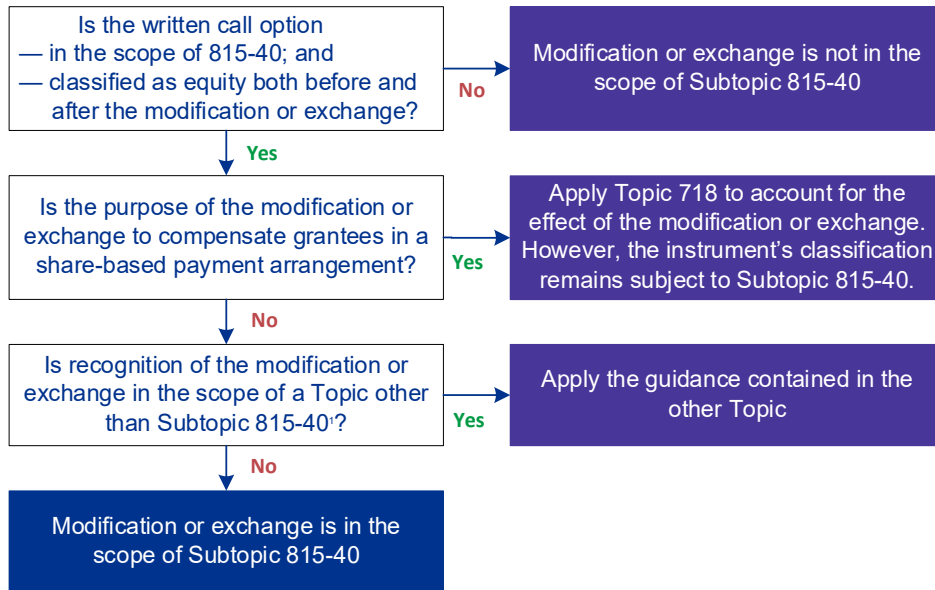
- a financing (and, if so, the type of financing – i.e. equity, debt origination or debt modification) or other arrangement; or
- a multiple-element arrangement (e.g. an arrangement involving both debt financing and equity financing).



Question 8.13.60

Which modifications or exchanges of written call options does Subtopic 815-40 provide guidance for?

Interpretive response: The considerations for determining whether a modification or exchange is in the scope of Subtopic 815-40 are summarized as follows. [\[815-40-35-14, 35-16\]](#)



Note:

1. Subtopic 815-40 provides recognition and measurement guidance for a modification or exchange in paragraphs 815-40-35-16 to 815-40-35-18.

Subtopic 815-40's Example 22, Case C (reproduced below) provides an example of a modification that is not accounted for under Subtopic 815-40. For further guidance on share-based payment arrangements, see KPMG Handbook, [Share-based payments](#).



Excerpt from ASC 815-40

> Illustrations

- > Example 22: Modification of Equity-Classified Warrants

55-49 This Example illustrates the application of the guidance in paragraphs 815-40-35-14 through 35-17. Entity A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have a 10-year term and are exercisable at any time. At issuance, Entity A determines that the warrants are equity classified in accordance with this Subtopic. Prior to the modifications described in Cases A, B, and C, the warrants have not been modified since issuance and remain equity classified...

- • > Case C: Warrant Modification Recognized as Compensation

55-52 Entity A reduces the exercise price of the warrants to \$8 per share for the remaining term as a consideration for certain services received from the warrant holder. Entity A determines that the warrants remain equity classified in accordance with this Subtopic after the modification. Entity A considers the guidance in paragraphs 815-40-35-14 through 35-15 and determines that the circumstances of the warrant modification indicate that the modification is executed to compensate the warrant holder for the services provided to Entity

A. Because the warrant modification is executed to compensate the warrant holder in a **share-based payment arrangement**, Entity A accounts for that modification by applying the requirements in Topic 718 (that is, the guidance in paragraphs 815-40-35-16 through 35-17 is not applicable).



Question 8.13.70

How does an entity measure and recognize the effect of a modification or exchange of a freestanding equity-classified written call option?

Interpretive response: When the modification or exchange is in the scope of Subtopic 815-40, how the entity measures and recognizes its effect depends on the nature of the modification or exchange, as summarized in the following table. Question 8.13.80 addresses how to determine the nature of the modification or exchange. [815-40-35-16 – 35-17, 470-50-40-12(a), 40-12A, 40-17A, 40-18A, ASU 2021-04.BC19]

Nature of the modification or exchange	Measurement of the effect	Recognition of the effect
<p>Equity issuance. The modification or exchange is directly attributable to a proposed or actual equity offering (e.g. to induce exercise of freestanding equity-classified warrants) See Subtopic 815-40's Example 22, Case A (reproduced below).</p>	Measured as any increases – but not decreases – in the written call option's fair value.	Recognized as an equity issuance cost; see section 5.10.
<p>Debt origination. The modification or exchange is part of or directly related to an issuance of a debt instrument</p>	Measured as any increases – but not decreases – in the written call option's fair value.	Recognized as a debt discount or debt issuance cost under Topic 835 (interest); see section 3.4.
<p>Debt modification – TDRs. The modification or exchange is part of or directly related to a modification or an exchange of an existing debt instrument and results in a TDR</p>	<p>We believe it depends on who holds the written call option.</p> <p>— Creditor. Measured as the change in the written call option's fair value, including increases and decreases</p>	<p>Included when projecting cash flows to determine whether a concession has been granted if the creditor is the holder of the written call option (see Question 4.2.120).</p> <p>How the effect is recognized under the guidance in Subtopic 470-60 (TDRs by debtors) when debt is modified depends on whether the carrying amount of the old debt is greater (or less) than the undiscounted cash flows of the new</p>

Nature of the modification or exchange	Measurement of the effect	Recognition of the effect
	<ul style="list-style-type: none"> — Third party. Measured as any increases – but not decreases – in the written call option's fair value 	debt and on whether the holder is a creditor or third party; see Question 4.3.20.
<p>Debt modification – other than TDR. The modification or exchange is part of or directly related to a modification or an exchange of an existing debt instrument and does not result in a TDR</p>	<p>It depends on who holds the written call option.</p> <ul style="list-style-type: none"> — Creditor. Measured as the change in the written call option's fair value, including increases and decreases — Third party. Measured as any increases – but not decreases – in the written call option's fair value <p>See also Questions 4.4.60, 4.5.75 and 4.6.45.</p>	<p>Included in performing the cash flow test to determine whether to apply extinguishment or modification accounting if the creditor is the holder of the written call option (see Question 4.4.60).</p> <p>How the effect is recognized depends on which of the following is applied. In both cases, whether the effect is capitalized or expensed depends on whether the holder is a creditor or third party.</p> <ul style="list-style-type: none"> — Extinguishment accounting: see Question 4.5.75 for guidance; or — Modification accounting: see Question 4.6.45 for guidance.
<p>Multiple-element transaction. The modification or exchange involves both debt financing and equity financing</p>	The total effect of the modification or exchange is allocated to the respective elements in the transaction.	The amount allocated to each element in the transaction is recognized under the guidance for that element.
<p>Other. The nature of the modification or exchange:</p> <ul style="list-style-type: none"> — is not an equity issuance, debt origination or debt modification; and — is not in the scope of any other Topics. <p>See also Subtopic 815-40's Example</p>	Measured as any increases – but not decreases – in the written call option's fair value.	<p>Recognized as a deemed dividend¹. However, the rights and privileges obtained (both stated and unstated) or other elements of the transaction are accounted for according to their substance (i.e. as a cost to the issuing entity) and not as a dividend if the modification or exchange is executed in exchange for an agreement by the written call option's holder to do any of the following:</p> <ul style="list-style-type: none"> — abandon certain acquisition plans;

Nature of the modification or exchange	Measurement of the effect	Recognition of the effect
22, Case C (reproduced after Question 8.13.60).		<ul style="list-style-type: none"> — forgo other planned transactions; — settle litigation; — settle employment contracts; or — voluntarily restrict its purchase of the issuer's (or the issuer's affiliates') shares within a stated time period.
<p>Note:</p> <ol style="list-style-type: none"> 1. An entity that presents EPS reduces income available to common stockholders in basic EPS. See KPMG Handbook, Earnings per share. 		



Excerpt from ASC 815-40

> Illustrations

• > Example 22: Modification of Equity-Classified Warrants

55-49 This Example illustrates the application of the guidance in paragraphs 815-40-35-14 through 35-17. Entity A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have a 10-year term and are exercisable at any time. At issuance, Entity A determines that the warrants are equity classified in accordance with this Subtopic. Prior to the modifications described in Cases A, B, and C, the warrants have not been modified since issuance and remain equity classified.

• • > Case A: Warrant Modification Recognized as an Equity Issuance Cost

55-50 Entity A reduces the exercise price of the warrants to \$9 per share for a 60-day period to induce exercise of the outstanding warrants. Entity A determines that the warrants remain equity classified in accordance with this Subtopic after the modification. Entity A considers the guidance in paragraphs 815-40-35-14 through 35-15 and determines that the circumstances of the warrant modification indicate that the modification is executed in contemplation of an equity offering (that is, to induce the imminent exercise of the outstanding warrants and raise equity capital). Entity A concludes that the incremental fair value of the outstanding warrants is an incremental cost directly attributable to a proposed equity offering. Entity A recognizes the incremental fair value of the outstanding warrants as an equity issuance cost in accordance with paragraph 815-40-35-17(a). At the date on which the modification is executed by Entity A and the warrant holder, Entity A recognizes deferred costs of an offering (calculated in accordance with paragraph 815-40-35-16) to be charged against the gross proceeds of the offering. See paragraphs 815-40-50-5 through 50-6 and 505-10-50-3 for disclosure guidance.

• • > Case B: Warrant Modification Recognized as a Dividend

55-51 Entity A extends the term of the outstanding warrants, which results in an increase in the fair value of the outstanding warrants. Entity A determines that the warrants remain equity classified in accordance with this Subtopic after the modification. The warrant holder is a nonemployee investor that has no other commercial relationship with Entity A. The modification is not executed in contemplation of an imminent equity offering or a financing transaction. Entity A considers the guidance in paragraphs 815-40-35-14 through 35-15 and determines that the circumstances of the warrant modification do not indicate that there are other transactions entered into contemporaneously or in contemplation of the warrant modification or other rights and privileges obtained or obligations incurred to achieve an overall economic effect. Entity A concludes that the warrant modification is not related to a financing or compensation for goods and services and is not within the scope of another Topic. At the date on which Entity A and the warrant holder execute the modification, Entity A recognizes the incremental fair value of the outstanding warrants as a dividend to the warrant holder in accordance with paragraph 815-40-35-17(d). See paragraphs 260-10-45-15 and 260-10-45-22 through 45-27 for earnings-per-share guidance and paragraphs 815-40-50-5 through 50-6 and 505-10-50-3 for disclosure guidance.



Question 8.13.80

What factors are considered when determining the nature of a modification or exchange of a freestanding equity-classified written call option?

Interpretive response: An entity considers the following: [815-40-35-15, ASU 2021-04.BC16]

- reasons for the modification or exchange;
- relationship of the written call option's holder to the entity;
- all terms and conditions of the modification or exchange;
- other transactions entered into contemporaneously or in contemplation of the modification or exchange;
- other rights and privileges obtained or obligations incurred (including services) as a result of the modification or exchange;
- the overall economic effects of the modification or exchange; and
- other relationships affecting the transaction.



Question 8.13.90

What disclosures are required for a modification or exchange of a freestanding equity-classified written call option?



Excerpt from ASC 815-40

> Issuer's Accounting for Modifications or Exchanges of Freestanding Equity-Classified Written Call Options

50-6 For a freestanding equity-classified written call option modified or exchanged during any of the periods presented and for which an entity has recognized the effect in accordance with paragraph 815-40-35-17, an entity shall disclose the following:

- a. Information about the nature of the modification or exchange transaction (see paragraph 815-40-35-15)
- b. The amount of the effect of the modification or exchange (see paragraph 815-40-35-16)
- c. The manner in which the effect of the modification or exchange has been recognized (see paragraph 815-40-35-17).

Interpretive response: An entity is required to disclose the following when a freestanding equity-classified written call option is modified or exchanged during any of the periods presented; see Question 8.13.70 about these items. [815-40-50-6]

Nature	Information about the nature of the modification or exchange transaction
Amount	The amount of the effect of the modification or exchange
Recognition	How the effect of the modification or exchange has been recognized

In addition, the disclosure requirements in the following paragraphs apply to the modification or exchange:

- 505-10-50-3: See section 5.12.40 and Question 5.12.30;
- 815-40-50-5: See section 8.17.

8.14 Reclassification of instruments



Excerpt from ASC 815-40

> Reclassification of Contracts

35-8 The classification of a contract (including **freestanding financial instruments** and embedded features) shall be reassessed at each balance sheet date. If the classification required under this Subtopic changes as a result of events during the period (if, for example, as a result of voluntary issuances of stock the number of authorized but unissued shares is insufficient to satisfy the maximum number of shares that could be required to net share settle the contract [see discussion in paragraph 815-40-25-20]), the contract shall be reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified.

35-9 If a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the contract during the period the contract was classified as equity shall be accounted for as an adjustment to stockholders' equity. The contract subsequently shall be marked to fair value through earnings. If an embedded feature no longer qualifies for the derivatives scope exception under this Subtopic, the feature shall be separated from its host contract and accounted for as a **derivative instrument** in accordance with Subtopic 815-10 and Subtopic 815-15 (if all of the criteria in paragraph 815-15-25-1 are met).

35-10 If a contract is reclassified from an asset or a liability to equity, gains or losses recorded to account for the contract at fair value during the period that the contract was classified as an asset or a liability shall not be reversed. The contract shall be marked to **fair value** immediately before the reclassification. An **embedded derivative** that qualifies for the derivatives scope exception upon reassessment under this Subtopic that was separated from its host contract and accounted for as a derivative instrument in accordance with Subtopic 815-10 shall be reclassified to equity. The previously bifurcated embedded derivative shall not be recombined with its host contract.

35-11 If a contract permits partial net share settlement and the total **notional amount** of the contract no longer can be classified as permanent equity, any portion of the contract that could be net share settled as of that balance sheet date shall remain classified in permanent equity. That is, a portion of the contract shall be classified as permanent equity and a portion of the contract shall be classified as an asset, a liability, or temporary equity, as appropriate.

35-12 If an entity has more than one contract subject to this Subtopic, and partial reclassification is required, there may be different methods that could be used to determine which contracts, or portions of contracts, shall be reclassified. Methods that would comply with this Section could include any of the following:

- a. Partial reclassification of all contracts on a proportionate basis
- b. Reclassification of contracts with the earliest inception date first
- c. Reclassification of contracts with the earliest maturity date first
- d. Reclassification of contracts with the latest inception or maturity date first
- e. Reclassification of contracts with the latest maturity date first.

35-13 The method of reclassification shall be systematic, rational, and consistently applied.

Regardless of whether they are classified as equity, or as an asset or a liability, all contracts in the scope of Subtopic 815-40 are reassessed each reporting

period to determine whether their classification continues to be appropriate. If an instrument classified in equity does not continue to meet the indexation and the equity classification guidance, it is reclassified as an asset or a liability. Conversely, an instrument classified as an asset or liability is reclassified to equity if it subsequently meets both the indexation and the equity classification guidance. If a classification change is required, it is done as of the date of the underlying event that caused the change. There is no limit on the number of times a contract may be reclassified. [815-40-35-8]

Question 8.14.10
What are examples of events that could cause an instrument to be reclassified?

Interpretive response: The following are some examples of events that could cause an instrument to be reclassified:

- availability or lack of sufficient authorized and unissued shares to share-settle an instrument;
- issuance of new equity-linked instruments that require delivery of shares – e.g. warrants, convertible debt/preferred stock, share based payments;
- change in functional currency of the entity;
- lapse of one of the terms that resulted in an adjustment to the settlement amount that failed the indexation requirements;
- lapse of an exercise contingency that failed the indexation requirements;
- modification of one of the terms of the instrument.

Question 8.14.20
How is the reclassification of a freestanding instrument accounted for?

Interpretive response: The accounting for a reclassification depends on the instrument's current classification, and the classification that is required going forward. [815-40-35-9 – 35-10]

Equity to asset or liability	Asset or liability to equity
<p>Step 1: Remeasure the instrument to its current fair value</p> <p>Step 2: Recognize change in fair value as an adjustment to equity</p> <p>Step 3: Reclassify the current fair value of the instrument to asset or liability</p> <p>Step 4: Subsequently measure the instrument at fair value, with changes to fair value recognized in earnings</p>	<p>Step 1: Remeasure the instrument to its current fair value</p> <p>Step 2: Recognize change in fair value in earnings</p> <p>Step 3: Reclassify the current fair value of the instrument to equity</p> <p>Step 4: Do NOT reverse previously recorded remeasurement gains or losses recognized in earnings, and do NOT subsequently remeasure the instrument (as long as it remains equity-classified)</p>



Question 8.14.30

How is the reclassification of an embedded feature accounted for?

Interpretive response: If an embedded feature no longer qualifies for the derivative scope exception, it is separated from the host and accounted for as a derivative under Subtopics 815-10 and 815-15. The embedded derivative is recorded at fair value on bifurcation with an offset to the carrying amount of the host contract. [815-40-35-9]

However, if an embedded feature that was previously bifurcated and accounted for as a derivative subsequently qualifies for the derivative scope exception upon reassessment, it cannot be recombined with the host contract, but instead is reclassified to equity. The bifurcated feature is marked to fair value immediately before reclassification with any changes in fair value reported through earnings before reclassification to equity. [815-40-35-10]



Question 8.14.40

Once an entity has sufficient authorized and unissued shares to justify equity classification of an instrument, does it reclassify the instrument?

Interpretive response: Yes. Often an entity is required to reclassify one or more of its contracts in the scope of Subtopic 815-40 because it has insufficient authorized and unissued shares. Similarly, a contract initially classified as either an asset or a liability may be required to be reclassified into equity if the entity authorizes additional shares such that there is now an adequate number of authorized and unissued shares to settle the contract.

If a contract permits partial net-share settlement and an entity does not have sufficient authorized and unissued shares to satisfy the entire contract, a portion of the contract that could be net-share settled is equity-classified and the remaining portion is classified as an asset or liability or temporary equity, as appropriate. [815-40-35-11]



Question 8.14.50

When an entity has more than one equity-classified instrument under Subtopic 815-40, how does it determine which instruments may require reclassification?

Interpretive response: If an entity has more than one contract subject to the equity classification guidance of Subtopic 815-40, there are different methods that can be used to determine which instruments, if any, must be reclassified in these situations.

These methods include the following: [815-40-35-12]

- partial reclassification of all contracts on a proportionate basis (assuming the contracts permit partial settlement);
- reclassification of contracts with the earliest inception date first;
- reclassification of contracts with the earliest maturity date first;
- reclassification of contracts with the latest inception date first;
- reclassification of contracts with the latest maturity date first.

The method used must be systematic, rational and consistently applied. [815-40-35-13]



Question 8.14.60

When an antidilution provision is triggered, does an entity reclassify warrants from equity to liability if it pays cash to the warrant holders?

Background: Assume that on June 1, Year 1, Issuer enters into an agreement to sell \$200 million of 8.0% notes due on June 1, Year 10.

In connection with the sale of the Notes, Issuer also issues warrants exercisable for a total of 10 million shares of its common stock at an exercise price of \$20 per share. The exercise price is subject to antidilution adjustments as set forth in the Warrant Agreement. One antidilution event is triggered when Issuer distributes annual cash dividends to common stockholders in excess of \$0.50 per share.

Upon issuance, the warrants meet the requirements for both the indexation guidance and the equity classification guidance. As a result, the warrants are classified as equity.

Issuer announces that it will issue an annual dividend of \$1 per share for Year 4. The Warrant Agreement provides Issuer with the ability to comply with the antidilution provision on a basis that the board of directors determines to be fair and appropriate in light of the basis on which holders of common stock participate in the transaction. Subsequently, Issuer decides to make a cash payment to the warrant holders in lieu of an adjustment to the exercise price and the number of shares to be issued to eliminate further dilution.

There have been no changes to the Warrant Agreement as a result of this decision. The option remains to either (1) adjust the warrant exercise terms or (2) pay cash to the warrant holders upon a defined antidilution event (as described above). This option was embedded in the original Warrant Agreement and is solely at Issuer's discretion.

Interpretive response: Based on the background example, reclassification is not required. None of the requirements of the equity classification guidance have failed because the payment of the antidilution provision in cash is solely at Issuer's discretion. Issuer has the ability to revert to adjusting the exercise price and number of shares to be issued upon declaring future dividends to common shareholders in excess of \$0.50, and the payment is equivalent to a partial physical settlement, which is acceptable under Subtopic 815-40 (net-share settlement should be assumed).

As a result, equity classification is still appropriate.

The cash payment of the dividend to the warrant holders is treated as an allocation of distributed earnings when applying the two-class method of EPS; see chapter 5 of KPMG Handbook, [Earnings per share](#).



Example 8.14.10

Reclassification of multiple equity-linked financial instruments

Issuer issues warrants on June 15, Year 1 that permit Holder to purchase 500,000 shares of its common stock for \$15 per share. The terms of the instrument provide Issuer with the option to either net-share or gross physically settle the warrants upon exercise and do not permit partial settlement.

On June 15, Year 1, Issuer has two million authorized and unissued shares available. In addition to the warrants issued on June 15, Year 1, Issuer has outstanding convertible debt, stock options, forward contracts and other warrants. The maximum number of shares that could be required to be delivered under all of these existing commitments is 1.9 million. Issuer follows a sequencing policy that reclassifies contracts with the latest inception date first.

On September 1, Year 1, Issuer issues 400,000 shares of its common stock for \$20 per share. The issuance of these common shares reduces the authorized but unissued shares available to satisfy the outstanding equity-linked instruments to 1.6 million (2 million – 400,000).

On June 15, Year 1, sufficient authorized and unissued shares are available to share settle the warrants issued on that date, because the maximum number of shares that could be required to be delivered under all of the existing commitments (including the warrants) is less than the number of authorized and unissued shares available. The warrants meet all of the requirements of the indexation guidance, and all of the additional requirements of the equity classification guidance. As a result, Issuer classifies the warrants in equity on June 15, Year 1.

On September 1, Year 1, there are not enough authorized and unissued shares available to share settle the warrants issued on June 15 in their entirety. Because of Issuer's sequencing policy for reclassifying contracts, the reduction in authorized and unissued shares first affects the latest issued warrants (i.e. those issued on June 15, Year 1). Because partial settlement is not permitted, the warrants are reclassified to liability in their entirety.

8.15 Derecognition

8.15.10 Overview



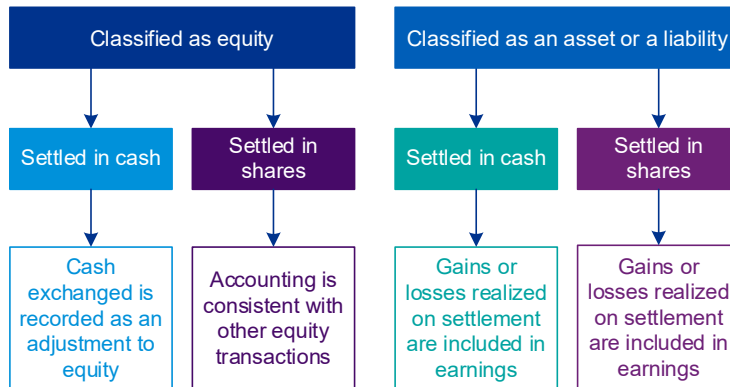
Excerpt from ASC 815-40

40-1 If contracts classified as permanent equity are ultimately settled in a manner that requires that the entity deliver cash, the amount of cash paid or received shall be reported as a reduction of, or an addition to, contributed capital.

40-2 If contracts classified as assets or liabilities are ultimately settled in shares, any gains or losses on those contracts shall continue to be included in earnings.

When an instrument in the scope of Subtopic 815-40 is settled, accounting for the settlement and derecognition depends on: [815-40-40-1 – 40-2]

- whether the contract was classified as equity or as an asset or a liability; and
- whether the contract was cash- or share-settled.



8.15.20 Settlement of equity-classified instruments



Question 8.15.10

How is an equity-linked financial instrument's settlement accounted for if it is classified as equity?

Interpretive response: If an equity-linked financial instrument classified as equity is settled in shares, the accounting for the settlement is consistent with other transactions in the entity's own stock. If the entity pays or receives cash at settlement, it is recorded with an offset to APIC. If the entity delivers or

receives shares at settlement, they are generally recorded as shares issued or treasury stock, respectively.

Example 8.15.10 illustrates physical, net-share and net-cash settlement of an equity-linked financial instrument that is classified as equity.



Example 8.15.10

Settlement of a freestanding warrant that is classified as equity

Issuer issues warrants on June 15, Year 1 that permit Holder to purchase 10,000 shares of its common stock for \$20 per share (par value \$1 per share). The warrants are exercisable at any time and have a 20-year term. Holder of the warrants paid \$50,000 to Issuer to acquire the warrants. The terms of the instrument give Issuer the option to physically, net-share or net-cash settle the warrants upon exercise.

Issuer concludes that the warrants meet the requirements of both the indexation and the equity classification guidance; therefore, it classifies the warrants as equity. On June 15, Year 1, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	50,000	
APIC		50,000
<i>To recognize warrants issued as equity.</i>		

On October 15, Year 5, Holder exercises all of the warrants, when Issuer's share price is \$40 per share.

Scenario 1: Physically settle

Issuer elects to physically settle the warrants. Therefore, Issuer issues 10,000 shares to Holder, receives \$200,000 of additional cash from Holder, and records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	200,000	
Common stock ¹		10,000
APIC ²		190,000
<i>To recognize physical settlement of warrants.</i>		
Notes:		
1. 10,000 shares × \$1 par value per share.		
2. Proceeds from settlement (\$200,000) – Par value (\$10,000).		

Scenario 2: Net-share settle

Issuer elects to net-share settle the warrants. As a result, Issuer delivers 5,000 shares to Holder.

Holder's gain on settlement of the warrants is the difference between the fair value of the shares on the settlement date of \$400,000 (10,000 shares × \$40 per share) and the settlement amount of \$200,000 (10,000 shares × \$20 per share). The gain of \$200,000 equates to 5,000 shares ($\$200,000 \div \40 per share).

Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
APIC	200,000	
Common stock ¹		5,000
APIC ²		195,000
<i>To recognize net-share settlement of warrants.</i>		
Notes:		
1. 5,000 shares × \$1 par value per share.		
2. Proceeds from settlement (\$200,000) – Par value (\$5,000).		

Scenario 3: Net-cash settle

Issuer elects to net-cash settle the warrants.

Therefore, Issuer delivers \$150,000 to Holder, which equates to Holder's gain on settlement of the warrants, and records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
APIC	150,000	
Cash		150,000
<i>To recognize net-cash settlement of warrants.</i>		

8.15.30 Settlement of asset- or liability-classified instruments



Question 8.15.20

How is an equity-linked financial instrument's settlement accounted for if it is classified as an asset or liability?

Interpretive response: If an equity-linked financial instrument classified as an asset or a liability is settled in cash, the fair value of the instrument is determined at settlement and any gain or loss not recognized in a prior period is recognized in earnings when the instrument is settled. If the entity delivers or receives shares at settlement, they are generally recorded as shares issued or treasury stock, respectively, at fair value.

Example 8.15.20 illustrates physical, net-share, and net-cash settlement of an equity-linked financial instrument that is classified as a liability.



Example 8.15.20

Settlement of a freestanding warrant that is classified as a liability

Assume the same facts as Example 8.15.10, except that the warrants are liability-classified because the terms of the warrant give Holder the option to physically, net-share, or net-cash settle the warrants upon exercise.

When it issues the warrants on June 15, Year 1, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	50,000	
Warrant liability		50,000
<i>To recognize warrants issued as a liability.</i>		

Throughout the life of the warrants, they are measured at fair value with changes therein recognized in earnings.

On October 15, Year 5, Holder exercises all of the warrants, when Issuer's share price is \$35 per share and the liability, prior to exercise, is recorded at \$125,000.

Scenario 1: Physically settle

Holder elects to require physical settlement of the warrants. Therefore, Issuer issues 10,000 shares to the holder and records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Loss on warrants ¹	25,000	
Warrant liability		25,000
<i>To remeasure the warrant liability to fair value upon settlement.</i>		
Cash	200,000	
Warrant liability	150,000	
Common stock ²		10,000
APIC ³		340,000
<i>To recognize physical settlement of warrants.</i>		
Notes:		
1. $((10,000 \text{ shares} \times \$35 \text{ current share price}) - (10,000 \text{ shares} \times \$20 \text{ exercise price})) - \text{previous carrying amount of } \$125,000.$		
2. $10,000 \text{ shares} \times \$1 \text{ par value per share.}$		
3. Fair value of shares issued (\$35) – Par value (\$1) for 10,000 shares.		

Scenario 2: Net-share settle

Holder elects to require net-share settlement of the warrants. As a result, Issuer delivers 4,285 shares to Holder (for simplicity, the fractional share has been ignored in this example).

Holder's gain on settlement of the warrants is the difference between the fair value of the shares on the settlement date of \$350,000 (10,000 shares × \$35 per share) and the settlement amount of \$200,000 (10,000 shares × \$20 per share). The gain of \$150,000 equates to 4,285 shares ($\$150,000 \div \35 per share).

Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Loss on warrants ¹	25,000	
Warrant liability		25,000
<i>To remeasure the warrant liability to fair value upon settlement.</i>		
Warrant liability	150,000	
Common stock ²		4,285
APIC ³		145,715
<i>To record net-share settlement of warrants.</i>		
Notes:		
1. $((10,000 \text{ shares} \times \$35 \text{ current share price}) - (10,000 \text{ shares} \times \$20 \text{ exercise price}) - \text{previous carrying amount of } \$125,000.$		
2. $4,285 \text{ shares} \times \$1 \text{ par value per share.}$		
3. $\text{Fair value of shares issued } (\$35) - \text{Par value } (\$1) \text{ for } 4,285 \text{ shares.}$		

Scenario 3: Net-cash settle

Holder elects to require net-cash settlement of the warrants.

Therefore, Issuer delivers \$150,000 to Holder, which equates to Holder's gain on settlement of the warrants and records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Loss on warrants ¹	25,000	
Warrant liability		25,000
<i>To remeasure the warrant liability to fair value upon settlement.</i>		
Warrant liability	150,000	
Cash		150,000
<i>To recognize net-cash settlement of warrants.</i>		
Note:		
1. $((10,000 \text{ shares} \times \$35 \text{ current share price}) - (10,000 \text{ shares} \times \$20 \text{ exercise price}) - \text{previous carrying amount of } \$125,000.$		

8.16 Applicability of Subtopic 815-40 to certain instruments

8.16.10 Certain convertible debt instruments



Excerpt from ASC 815-40

> Application of Additional Criteria to Convertible Debt Instruments and Other Hybrid Instruments

25-39 For purposes of evaluating under paragraph 815-15-25-1 whether an **embedded derivative** indexed to an entity's own stock would be classified in stockholders' equity if freestanding, the requirements of paragraphs 815-40-25-7 through 25-30 and 815-40-55-2 through 55-6 do not apply if the hybrid contract is a convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).

25-40 However, the requirements of paragraphs 815-40-25-7 through 25-30 and 815-40-55-2 through 55-6 do apply if an issuer is evaluating whether any other embedded derivative is an equity instrument and thereby excluded from the scope of Subtopic 815-10.

25-41 Instruments that provide the holder with an option to convert into a fixed number of shares (or equivalent amount of cash at the discretion of the issuer) for which the ability to exercise the option is based on the passage of time or a contingent event shall qualify for the exceptions included in paragraph 815-40-25-39. **Standard antidilution provisions** contained in an instrument do not preclude a conclusion that the instrument is convertible into a fixed number of shares.

25-42 Convertible preferred stock with a mandatory redemption date may qualify for the exception included in paragraph 815-40-25-39 if the economic characteristics indicate that the instrument is more akin to debt than equity. An entity shall consider the guidance in paragraph 815-15-25-17 in assessing whether the instrument is more akin to debt or equity. That paragraph explains that, if the preferred stock is more akin to equity than debt, an equity conversion feature would be clearly and closely related to that host instrument.

Whether a conversion option must meet the additional conditions in section 8.12 to be eligible for the own equity scope exception from derivative accounting depends on whether the holder may realize the value of the conversion option only by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the issuer's discretion). The terms of such a convertible debt instrument can also include exercise contingencies (see section 8.7) and standard antidilution provisions (see Question 8.8.150 and Example 8.8.80). [815-40-25-39, 25-41]

However, paragraph 815-40-25-39 provides an exception. If the holder of a convertible debt instrument may only realize the value of the conversion option

by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash, the additional conditions necessary for equity classification discussed in section 8.12 do not apply. However, such convertible debt instruments must still meet the requirements of the indexation guidance explained in sections 8.7 to 8.9. [815-40-25-39]

The additional conditions necessary for equity classification also do not apply to convertible preferred stock with a mandatory redemption date if the instrument's economic characteristics indicate the instrument is more like debt or equity. For guidance on determining whether the host contract is more like debt or equity, see section 9.3.40.



Question 8.16.10

What are some examples of convertible instruments that qualify for the exception in paragraph 815-40-25-39, and some that do not?

Interpretive response: The terms and conditions of convertible debt instruments (or convertible preferred stock that is debt-like) frequently include provisions that result in the instrument not qualifying for the paragraph 815-40-25-39 exception.

The following table provides examples of convertible debt and whether the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).

Exception applies	Exception does not apply
A conversion option that permits the issuer of the option to settle either in a fixed number of shares or an equivalent amount of cash.	A conversion option that permits the issuer to settle by delivering any combination of cash or shares upon exercise.
A conversion option that adjusts the conversion ratio in the event of a stock split, in order to maintain the value of the conversion option – i.e. a standard antidilution provision is acceptable.	A conversion option that adjusts the conversion ratio in the event of an all-cash dividend that is neither large nor nonrecurring – i.e. any provision that is not considered a standard antidilution provision is unacceptable.
	A conversion option that allows the principal amount to be settled in cash and the conversion spread to be settled in cash and/or shares.
	A make-whole provision that results in the number of shares awarded upon exercise being variable.

**Example 8.16.10****Convertible debt where additional conditions for equity classification do not apply**

Issuer issues a convertible debt instrument with a par value of \$1,000. On conversion, Holder will receive either 10 shares of common stock or cash equal to the value of 10 shares of common stock, at Issuer's option.

The terms of the contract allow for an adjustment to the conversion ratio of the contract to neutralize the effect to Issuer's share price if there is a stock split.

If Issuer elects to share settle the instrument, it is required to do so in registered shares. The contract explicitly states that failure to deliver registered shares requires cash settlement. The conversion feature in the convertible debt meets the definition of a derivative under Topic 815. Therefore, Issuer has to evaluate if it meets the own equity scope exception from derivative accounting.

Application of indexation guidance

Step 1	Step 1 does not apply because the terms of the instrument include no contingent exercise provisions.
Step 2	<p>Issuer determines that the settlement provisions meet the fixed-for-fixed requirements. This is because on exercise, the settlement amount will equal the difference between the fair value of 10 shares (a fixed number of Issuer's shares) and \$1,000 (a fixed amount).</p> <p>The provision that allows an adjustment to the strike price if there is a stock split does not cause the instrument to fail Step 2 of the indexation guidance because it is a standard antidilution provision, which is meant to maintain the value of the instrument in the event of a stock split.</p>

As a result, Issuer concludes that the convertible debt meets the requirements of the indexation guidance and proceeds to analyze the instrument under the equity classification guidance.

Application of equity classification guidance

Issuer concludes that the convertible debt instrument meets the paragraph 815-40-25-39 exception because Holder can realize the value of the conversion option only by exercising the option and receiving the entire proceeds in either a fixed number of shares (i.e. 10 shares) or the equivalent amount of cash, at Issuer's option.

The provision that allows an adjustment to the strike price if there is a stock split does not preclude the instrument from qualifying for the exception. This is because the guidance allows for standard antidilution provisions in the terms of a convertible debt without affecting the debt's eligibility for the exception.

Therefore, Issuer does not analyze the convertible debt instrument under the additional conditions for equity classification discussed in section 8.12.

Conclusion

Issuer concludes that the instrument meets the paragraph 815-40-25-39 exception and the conversion option meets the requirements of both the indexation guidance and the equity classification guidance. Therefore, the

instrument qualifies for the own equity scope exception from derivative accounting.

No further analysis of the additional equity classification guidance discussed in section 8.12 is required. The fact that the instrument contains an explicit provision that requires Issuer to cash settle the instrument if it is unable to deliver the required registered shares is not relevant because the instrument meets the paragraph 815-40-25-39 exception. As a result, Issuer does not bifurcate the conversion feature.

Note: If the convertible debt instrument did not meet the paragraph 815-40-25-39 exception, the conversion feature would not satisfy the requirements of the equity classification guidance. This is because it contains an explicit provision that requires Issuer to cash settle the instrument if it is unable to deliver the required registered shares.

8.16.20 Certain freestanding instruments



Excerpt from ASC 815-40

- > Application of this Subtopic to Specific Instruments
- • > Forward Sale Contracts, Written Call Options or Warrants, and Purchased Put Options

55-13 The issuing entity (the seller) agrees to sell shares of its stock to the buyer of the contract at a specified price at some future date. The contract may be settled by physical settlement, net share settlement, or net cash settlement, or the issuing entity or counterparty may have a choice of settlement methods. The guidance in this Subtopic would be applied as follows.

	One Settlement Method			Entity Choice			Counterparty Choice		
	Physical ^(a)	Net Share	Net Cash	Net Share or Physical ^(a)	Net Share or Net Cash	Net Cash or Physical ^(a)	Net Share or Physical ^(a)	Net Share or Net Cash	Net Cash or Physical ^(a)
(1) Initial Classification:									
Equity ^(b)	x	x		x	x	x	x		
Asset or Liability			x					x	x
(2) Initial Measurement, Subsequent Classification and Measurement:									
Fair value, permanent equity—no changes in fair value ^(b)	x	x		x	x ^(c)	x ^(c)	x		
Fair value, asset or liability—adjusted for changes in fair value ^(d)			x					x ^(e)	x ^(e)

- (a) Physical settlement of the contract requires that the entity deliver shares to the holder in exchange for cash.
- (b) Equity or temporary equity classification is only appropriate if the conditions in Section 815-40-25 do not require asset or liability classification of the contract.
- (c) If the contracts are ultimately settled in net cash, the amount of cash paid or received should be reported as a reduction of, or an addition to, contributed capital.
- (d) Subsequent changes in fair value should be reported in earnings and disclosed in the financial statements.
- (e) If the contracts are ultimately settled in shares, any gains or losses on those contracts should continue to be included in earnings.

Note: In all cases above, the contracts must be reassessed at each reporting period in order to determine whether or not the contract must be reclassified.

- • > Purchased Call Options

55-14 The entity (the buyer) purchases call options that provide it with the right, but not the obligation, to buy from the seller, shares of the entity's stock at a specified price. If the options are exercised, the contract may be settled by physical settlement, net share settlement, or net cash settlement, or the issuing entity or the counterparty may have a choice of settlement methods. The entity should follow the preceding table in accounting for purchased call options.

Subtopic 815-40 provides implementation guidance that summarizes the requirements for initial and subsequent classification and measurement of certain freestanding instruments. [815-40-55-13 - 55-14]

The first section of the above table (Initial Classification) is grounded in the basic premise of the equity classification guidance – i.e. for an instrument to be equity-classified, the terms of the contract must either require share settlement or provide the issuer with the option of settlement method. See section 8.10. [815-40-55-13]

The second section of the above table (Initial Measurement, Subsequent Classification and Measurement) summarizes the guidance discussed in section 8.13. That guidance requires an instrument classified as equity to be initially measured at fair value within equity, with no subsequent changes to fair value being recognized. An instrument classified as a liability (or asset) is also initially measured at fair value. However, subsequent changes to fair value of these instruments are recognized in earnings. [815-40-55-13]

The second section of the table also indicates the accounting treatment upon derecognition based on an instrument's classification. See section 8.15. [815-40-55-13]

8.16.30 Accelerated share repurchase programs

As discussed in section 8.4.40, an ASR program is accounted for as two separate transactions: a treasury stock repurchase and a forward contract to sell shares. If the forward contract is not in the scope of Topic 480, it is analyzed under Subtopic 815-40 to determine whether it is accounted for as an equity instrument or as an asset or liability.



Question 8.16.20

What are some common provisions that would cause an ASR's forward contract to fail the equity classification requirements of Subtopic 815-40?

Interpretive response: Examples of provisions that would cause an ASR's forward contract to fail the equity classification requirements of Subtopic 815-40 include the following (not exhaustive).

- A settlement provision that includes compensatory amounts due to the investment bank for its role as the calculation agent in determining the settlement amounts. Such a provision may indicate that settlement is not fixed-for-fixed, because it is not calculated based on the fair value of a fixed number of the entity's shares, and a fixed amount.
- A settlement provision may provide solely for cash payment to the investment bank on settlement, which would not meet the conditions for equity classification.

Additionally, ASR programs are often documented in a standard ISDA agreement. As discussed in section 8.3, those agreements may include provisions that result in a forward contract failing the requirements of the indexation or the equity classification guidance of Subtopic 815-40. However, in some cases, the parties may override the provisions in an ISDA Master Agreement through incorporating different provisions in the confirmation.

Examples of provisions in ISDA Master Agreements that may cause a forward contract to fail the requirements of Subtopic 815-40 (unless overridden) include the following.

- **Indexation guidance failed.** Provisions that expose the entity to the effects of changes in a dealer's *actual* hedge position (instead of to a commercially reasonable or standard hedge position) if certain events occur – e.g. if a significant transaction occurs that creates discontinuities in the entity's share price (see section 8.8.50).
- **Equity classification guidance failed.** Provisions allowing the counterparty to the transaction to net-cash settle the contract if an event occurs that is outside the entity's control (see section 8.8.10). [2007 AICPA Conf]

8.17 Presentation and disclosure



Excerpt from ASC 815-40

50-1A The disclosure guidance in this Section should help a user of financial statements understand the following:

- a. Information about the terms and features of contracts in an entity's own equity within the scope of this Subtopic
- b. How those instruments have been reflected in the issuer's statement of financial position and statement of financial performance
- c. Information about events, conditions, and circumstances that can affect how to assess the amount or timing of an entity's future cash flows but has not yet been reflected in the financial statements.

50-2 The disclosure guidance in this Subtopic applies to freestanding instruments that are potentially indexed to, and potentially settled in, an entity's own equity, regardless of whether the contract meets the criteria to qualify for the scope exception in Sections 815-40-15 and 815-40-25. Some contracts that are classified as assets or liabilities meet the definition of a **derivative instrument** under the provisions of Subtopic 815-10. The related

disclosures that are required by Sections 815-10-50, 815-25-50, 815-30-50, and 815-35-50 also are required for those contracts. Equity-classified contracts under the provisions of this Subtopic are not required to provide the disclosures required by Section 505-10-50, other than those described in paragraph 815-40-50-5.

> Fair Value Disclosures

50-2A Changes in the fair value of all contracts classified as assets or liabilities shall be disclosed in the financial statements as long as the contracts remain classified as assets or liabilities. [Content moved from paragraph 815-40-50-1]

> Reclassifications and Related Accounting Policy Disclosures

50-3 Contracts within the scope of this Subtopic may be required to be reclassified into (or out of) equity during the life of the instrument (in whole or in part) pursuant to the provisions of paragraphs 815-40-35-8 through 35-13. An issuer shall disclose contract reclassifications (including partial reclassifications), the reason for the reclassification, and the effect on the issuer's financial statements.

50-4 The determination of how to partially reclassify contracts subject to this Subtopic is an accounting policy decision that shall be disclosed pursuant to Topic 235.

> Interaction with Disclosures about Capital Structure

50-5 The disclosures required by Section 505-10-50 apply to all contracts within the scope of this Subtopic as follows:

- a. In the case of an option or forward contract indexed to the issuer's equity, the pertinent information to be disclosed under Section 505-10-50 about the contract includes all of the following:
 1. The forward rate
 2. The option strike price
 3. The number of issuer's shares to which the contract is indexed
 4. The settlement date or dates of the contract
 5. The issuer's accounting for the contract (that is, as an asset, liability, or equity).
- b. If the terms of the contract provide settlement alternatives, those settlement alternatives shall be disclosed under Section 505-10-50, including all of the following:
 1. Who controls the settlement alternatives and a description of those alternatives
 2. The maximum number of shares that could be required to be issued to net share settle a contract, if applicable. Paragraph 505-10-50-3 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.
- c. If a contract does not have a fixed or determinable maximum number of shares that may be required to be issued, the fact that a potentially infinite number of shares could be required to be issued to settle the contract shall be disclosed under Section 505-10-50.
- d. For each settlement alternative, the amount that would be paid, or the number of shares that would be issued and their fair value, determined

- under the conditions specified in the contract if the settlement were to occur at the reporting date and how changes in the fair value of the issuer's equity shares affect those settlement amounts (for example, the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each \$1 decrease in the fair value of one share) shall be disclosed under Section 505-10-50. (For some issuers, a tabular format may provide the most concise and informative presentation of these data.)
- e. The disclosures required by paragraph 505-10-50-11 shall be made for any equity instrument in the scope of this Subtopic that is (or would be if the issuer were a public entity) classified as temporary equity. (That paragraph applies to redeemable stock issued by nonpublic entities, regardless of whether the private entity chooses to classify those securities as temporary equity.)
 - f. The disclosures required by paragraph 505-10-50-18 also shall be made for an equity-classified contract within the scope of this Subtopic that is entered into in connection with the issuance of convertible preferred stock.

If an equity-linked financial instrument that is in the scope of Subtopic 815-40 is classified as an asset or a liability in the entity's financial statements, changes in its fair value must be disclosed. Further, if the instrument qualifies as a derivative, the disclosure requirements for derivative instruments also apply. [\[815-40-50-1 – 50-2\]](#)

As discussed in section 8.14, an equity-linked financial instrument may need to be reclassified into or out of equity throughout its term. When reclassifications occur, that fact is disclosed along with the reason for the reclassification, and its effect on the entity's financial statements. The entity must also disclose its policy for partial reclassifications, if applicable. [\[815-40-50-3 – 50-4\]](#)

Finally, certain disclosure requirements of Subtopic 505-10 apply to financial instruments in the scope of Subtopic 815-40. See section 5.12. [\[815-40-50-5\]](#)

9. Hybrid instruments with embedded features

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New item added in this edition: **

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- 9.2.10 Instruments subject to Subtopic 815-15
- 9.2.20 Scope exception

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- 9.2.20 What is an embedded feature?
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- 9.2.10 Embedded foreign currency feature

9.3 Bifurcation analysis: The accounting model

- 9.3.10 Overview
- 9.3.20 Step 1: Determine if hybrid instrument is measured at fair value
- 9.3.30 Step 2: Identify the embedded features
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- 9.3.75 Are convertible preferred equity certificate (CPECs) hybrid instruments issued in the form of shares?
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- 9.4.20 Hybrid instruments with embedded features that are separated

Questions

- 9.4.10 Can an embedded feature be allocated a fair value that exceeds proceeds received for the hybrid instrument?
- 9.4.20 How is a bifurcated embedded derivative and its host contract measured?
- 9.4.30 How is a host contract accounted for after an embedded derivative has been bifurcated?
- 9.4.40 What is the initial fair value of a non-option embedded derivative?
- 9.4.50 Are the terms for an option-based embedded derivative adjusted when determining the initial fair value?

9.5 Subsequent measurement

- 9.5.10 Hybrid instruments with embedded derivatives that are not separated
- 9.5.20 Hybrid instruments with embedded derivatives that are separated
- 9.5.30 Reassessment of embedded derivatives
- 9.5.40 Recognition and measurement of a reassessed embedded derivative

Questions

- 9.5.10 How is a hybrid instrument measured in subsequent periods when its embedded derivative is not separated?
- 9.5.20 When the fair value option is elected, are all changes in fair value reported in earnings?
- 9.5.30 How is a bifurcated embedded derivative measured in subsequent periods?
- 9.5.40 When does an entity need to reevaluate an embedded derivative for bifurcation?
- 9.5.50 Does the determination that an embedded derivative is clearly and closely related to the host contract ever need to be reassessed?
- 9.5.60 Is there any limit to how many times an embedded derivative should be reassessed?
- 9.5.70 How is an embedded derivative measured and recorded when it is not initially bifurcated but is bifurcated in a subsequent period?

- 9.5.80 How is a bifurcated embedded derivative recorded when it was previously accounted for as a separate component of equity?
- 9.5.90 How is an embedded derivative (other than a conversion option or other equity-linked feature) measured and recorded when it no longer qualifies for bifurcation in subsequent periods?
- 9.5.100 How is an embedded conversion option (or other equity linked feature) measured and recorded when it no longer qualifies for bifurcation in subsequent periods?

Example

- 9.5.10 Subsequent accounting for a hybrid debt instrument and its bifurcated embedded derivative

9.6 Presentation and disclosure**Questions**

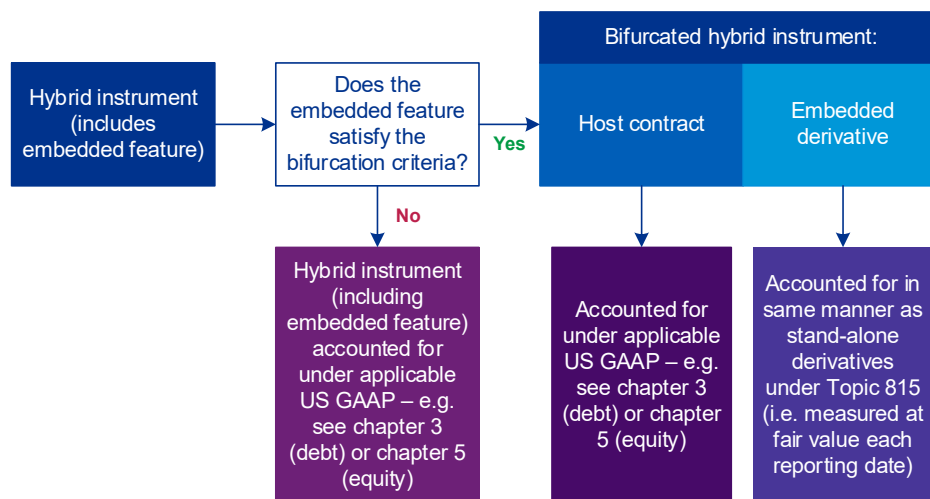
- 9.6.10 What are the presentation and disclosure requirements for a hybrid instrument with a bifurcated embedded derivative?
- 9.6.20 What are the presentation and disclosure requirements for a hybrid instrument measured at fair value?
- 9.6.30 What are the disclosure requirements when a bifurcated conversion option no longer meets the requirements to be bifurcated?

9.1 How the standard works

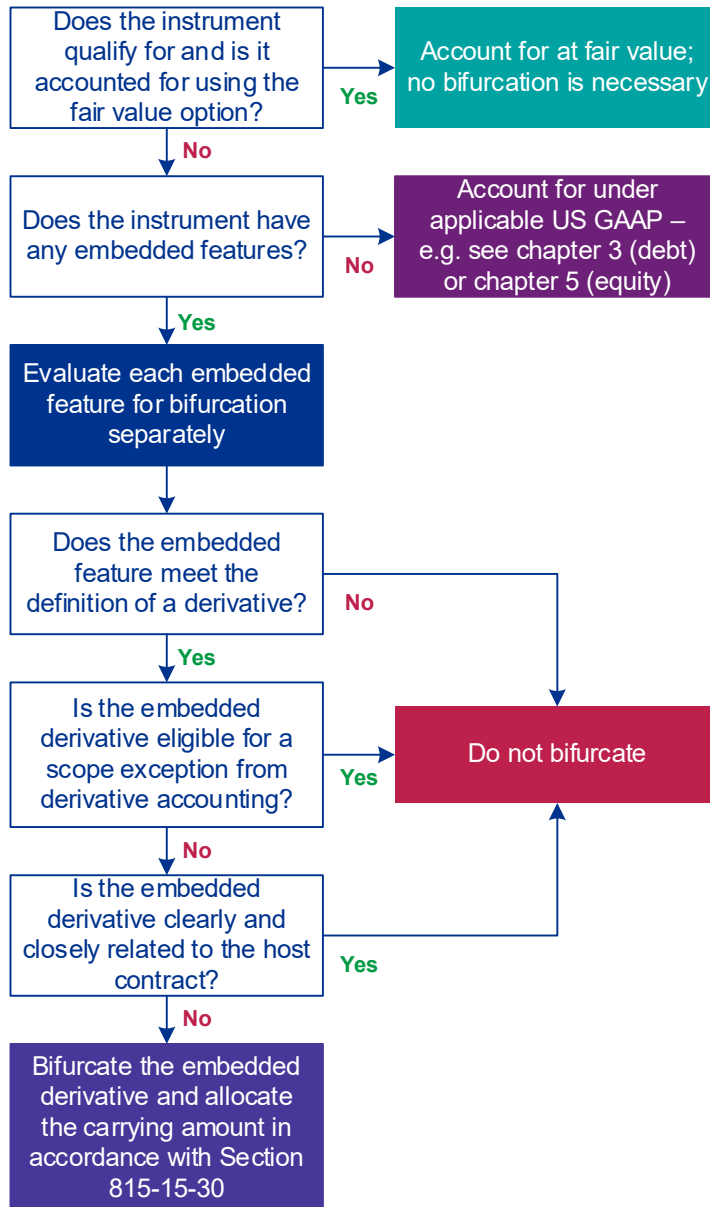
When a financial instrument contains an embedded feature and does not, in its entirety, meet the definition of a derivative, it is called a hybrid instrument.

How a hybrid instrument is accounted for depends on whether the embedded feature is separated (i.e. bifurcated) from the rest of the hybrid instrument. One of the criteria for bifurcation is that the embedded feature meets the definition of a derivative. If this criterion and other bifurcation criteria are satisfied, the embedded derivative is accounted for separately from the remaining part of the hybrid instrument, which is called the host contract.

The accounting for hybrid instruments is summarized as follows.



The analysis of whether an embedded feature should be bifurcated is summarized as follows.



Accounting for hybrid instruments that contain embedded features can be complex and requires significant judgment. This chapter provides an overview of the accounting treatment for hybrid instruments that contain embedded features and some considerations specific to debt and equity instruments. Chapter 3 of KPMG Handbook, [Derivatives and hedging](#), provides in-depth guidance on the analysis and accounting for embedded derivatives.

9.2 Scope

9.2.10 Instruments subject to Subtopic 815-15



Excerpt from ASC 815-15

> Entities

15-1 The guidance in this Subtopic applies to all entities.

> Instruments

15-2 The guidance in this Subtopic applies only to contracts that do not meet the definition of a **derivative instrument** in their entirety.

20 Glossary

Embedded Derivative

Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.

Hybrid Instrument

A contract that embodies both an embedded derivative and a host contract.

Subtopic 815-15 provides guidance on whether to bifurcate an embedded derivative from a host contract. Therefore, the Subtopic applies only to hybrid instruments – i.e. instruments with embedded derivatives. [815-15 Glossary]



Question 9.2.10

Does Subtopic 815-15 apply to an instrument that meets the definition of a derivative in its entirety?

Interpretive response: No. The guidance in Subtopic 815-15 applies to contracts that do not meet the definition of a derivative, such as a debt instrument or certain equity instruments. A contract that is a derivative in its entirety is accounted for as a derivative under Subtopic 815-10 and is not in the scope of Subtopic 815-15. [815-15-15-2]



Question 9.2.20

What is an embedded feature?

Interpretive response: As it relates to a debt or equity instrument, an embedded feature is a provision of the instrument that could affect the

instrument's contractually promised cash flows or the value of its other exchanges. [815-15-20]

For example, a term loan is issued for \$1,000. It is due in five years and pays 8% interest. After three years, the issuer can pay off the debt early for no penalty. In this simple example, the provision that allows for payoff of the debt before the stated term is an embedded feature because it affects the cash flows required in the contract (i.e. payoff in five years).

Question 9.3.50 contains examples of common embedded features.

9.2.20 Scope exception



Excerpt from ASC 815-15

- > Certain Foreign Currency Transactions

15-5 Unsettled foreign currency transactions, including financial instruments, shall not be considered to contain embedded foreign currency derivatives under this Subtopic if the transactions meet all of the following criteria:

- They are monetary items.
- They have their principal payments, interest payments, or both denominated in a foreign currency.
- They are subject to the requirement in Subtopic 830-20 to recognize any foreign currency transaction gain or loss in earnings.

Subtopic 815-15 contains several scope exceptions from the embedded derivatives accounting model; however, only one of these scope exceptions applies to hybrid debt instruments. That exception relates to certain foreign currency derivatives embedded in hybrid debt instruments.



Question 9.2.30

What foreign currency transactions fall in the scope exception for embedded foreign currency derivatives?

Interpretive response: A hybrid debt instrument is not in the scope of Subtopic 815-15 if: [815-15-15-5]

- its principal payments and/or interest payments are denominated in a foreign currency; and
- it is subject to recognition of foreign currency transaction gains and losses under Subtopic 830-20.

However, the same scope exception does not apply when an instrument is combined with a foreign currency option – e.g. a term loan that requires repayment in US dollars but also provides the option to repay the loan in a fixed amount of Japanese yen. This option to repay the loan in Japanese yen does

not exclude the instrument from the scope of Subtopic 815-15, meaning that the option is evaluated under this Subtopic for bifurcation.



Example 9.2.10

Embedded foreign currency feature

Issuer issues a \$100,000 debt obligation that matures in five years. The principal is denominated in US dollars and the interest is denominated in Japanese yen. Issuer's functional currency is the US dollar.

A portion of the instrument related to the periodic interest payments denominated in yen is subject to the requirements of Subtopic 830-20 to recognize the foreign currency transaction gain or loss in earnings. Therefore, this feature meets the requirements for the embedded foreign currency derivatives scope exception, causing the instrument to fall outside the scope of Subtopic 815-15. [815-15-15-5]

9.3 Bifurcation analysis: The accounting model

9.3.10 Overview



Excerpt from ASC 815-15

25-1 An **embedded derivative** shall be separated from the host contract and accounted for as a **derivative instrument** pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The **hybrid instrument** is not remeasured at **fair value** under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of Subtopic 815-10 and this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

Once an entity identifies an embedded feature in a debt or equity instrument (the host contract), it determines whether it needs to separate (or bifurcate) the embedded feature from the host contract and account for the embedded feature and host contract separately.

**Question 9.3.10****When is an embedded feature bifurcated from its host contract?**

Interpretive response: There are three criteria to evaluate in determining whether an entity needs to bifurcate the embedded feature. [815-15-25-1]

Criterion 1	The economic characteristics and risks of the embedded feature are not clearly and closely related to the economic characteristics and risks of the host contract.
Criterion 2	The hybrid instrument is not remeasured at fair value under otherwise applicable GAAP, with changes in fair value reported in earnings as they occur.
Criterion 3	A separate instrument with the same terms as the embedded feature would be accounted for as a derivative instrument.

There is no requirement to evaluate the three criteria in any particular sequence. In practice, the analysis is simplified if it is readily determined that any one criterion is not met. As highlighted in the decision tree in section 9.1, the following five-step decision sequence provides further guidance on how to apply these criteria in a simplified manner.

9.3.20 Step 1: Determine if hybrid instrument is measured at fair value

**Excerpt from ASC 815-15****> Fair Value Election for Hybrid Financial Instruments**

25-4 An entity that initially recognizes a hybrid financial instrument that under paragraph 815-15-25-1 would be required to be separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings and, if paragraph 825-10-45-5 is applicable, other comprehensive income). A financial instrument shall be evaluated to determine that it has an embedded derivative requiring bifurcation before the instrument can become a candidate for the fair value election.

25-5 The fair value election shall be supported by concurrent documentation or a preexisting documented policy for automatic election. That recognized hybrid financial instrument could be an asset or a liability and it could be acquired or issued by the entity. The fair value election is also available when a previously recognized **financial instrument** is subject to a **remeasurement event (new basis event)** and the separate recognition of an embedded derivative. The fair value election may be made instrument by instrument. For purposes of this paragraph, a remeasurement event (new basis event) is an event identified in generally accepted accounting principles, other than the recording of a credit

loss under Topic 326, or measurement of an impairment loss through earnings under Topic 321 on equity investments, that requires a financial instrument to be remeasured to its fair value at the time of the event but does not require that instrument to be reported at fair value on a continuous basis with the change in fair value recognized in earnings. Examples of remeasurement events are business combinations and significant modifications of debt as defined in Subtopic 470-50.

25-6 The fair value election shall not be applied to the hybrid instruments described in paragraph 825-10-50-8.

An embedded feature is not bifurcated when an entity has elected to measure the entire hybrid instrument at fair value through earnings (Criterion 2 in Question 9.3.10). In such a case it is unnecessary to evaluate the other criteria. [815-15-25-5]



Question 9.3.20

When is an entity permitted to make the election to measure a hybrid instrument at fair value through earnings?

Interpretive response: An entity can elect to apply the fair value option at the following times:

- when the entity first recognizes the instrument, including when the entity determines that an embedded feature should be bifurcated and recorded separately; and [815-15-25-4]
- when there is a remeasurement event, such as a business combination. [825-10-25-5]



Question 9.3.30

Are all hybrid instruments permitted to be measured at fair value through earnings?

Interpretive response: No. Topic 825 provides a list of instruments for which the fair value option cannot be elected. Among them are financial instruments that are, in whole or in part, classified by the issuer in stockholders' equity (including temporary equity), including: [825-10-50-8]

- equity instruments that are issued by the entity and are classified in stockholders' equity on the balance sheet;
- preferred shares that are classified in either temporary equity or permanent equity, regardless of whether they contain an equity host or a debt host; see section 9.3.40 for guidance related to the nature of the host contract; and

- a convertible debt instrument with a conversion option that is separately recorded in equity – e.g. the instrument was issued at a substantial premium. Chapter 10 discusses convertible debt instruments.

9.3.30 Step 2: Identify the embedded features



Excerpt from ASC 815-15

25-2 The notion of an embedded derivative in a hybrid instrument refers to provisions incorporated into a single contract, and not to provisions in separate contracts between different counterparties. Paragraph 815-10-15-6 states that an option that is added or attached to an existing debt instrument by another party results in the investor having different counterparties for the option and the debt instrument and, thus, the option shall not be considered an embedded derivative.

To determine whether a debt or equity instrument is a hybrid instrument in the scope of Subtopic 815-15, an entity needs to identify all embedded features in the instrument.



Question 9.3.40

How are embedded features identified?

Interpretive response: Subtopic 815-15 does not provide specific guidance about how to identify all the features that are embedded in an instrument. As discussed in Question 9.2.20, an embedded feature is a provision in an agreement that could affect the cash flows contractually promised in the agreement in a manner similar to a derivative instrument.

Using this definition, any provision in the contract that affects contractually promised cash flows is identified as an embedded feature that requires further evaluation – except for foreign currency features in debt instruments if they meet the criteria discussed in Question 9.2.30. [\[815-15 Glossary\]](#)

However, the notion of an embedded derivative does not contemplate features that may be sold or traded separately from the contract in which those rights and obligations are embedded. If they meet the definition of a derivative, such features are considered attached freestanding instruments instead of embedded derivatives.

For example, the following types of features found in some debt and equity instruments are not embedded derivatives, but instead are freestanding financial instruments that are analyzed under Subtopic 815-10: [\[815-10-15-5 to 15-7\]](#)

- an attached option with a different counterparty; and
- terms of an instrument that at the instrument's issuance include an option feature that is explicitly transferable to a third party independent of the instrument.

See section 6.3 for further discussion on freestanding and embedded financial instruments.



Question 9.3.50

What are common examples of embedded features in debt and equity instruments?

Interpretive response: All contractual terms of the debt or equity contracts should be carefully analyzed to identify embedded features that may require further evaluation.

The following are some common examples of embedded derivatives that are found in debt and equity agreements.

Example	Description
Call option	Allows the issuer of the instrument to redeem the instrument before the maturity date.
Put option	Allows the holder of the instrument to redeem the instrument before the maturity date.
Conversion option	Allows either the holder or issuer of the instrument to convert it into another instrument.
Foreign currency option	Allows the issuer to repay the instrument with a different currency than that denominated in the contract.
Contingent interest feature	Requires additional interest to be paid to the creditor if certain events occur – e.g. failure to comply with debt covenants/default, failure to timely file with the SEC.
Interest make-whole feature	In certain circumstances (e.g. early conversion or redemption), requires an amount to be paid to the creditor equal to the present value of the debt's remaining contractual interest cash flows.
Time value make-whole feature	Provides the holder with additional consideration, which may be payable in cash or shares, if certain events occur before specified dates – e.g. Issuer calls the debt or there is a change in control.
Term-extending option	Enables one party to extend the remaining term to maturity or automatically extends the maturity when triggered by a specific event or condition.
Overallotment option or greenshoe provisions	Allows underwriter to call additional securities of the issuer if the securities offered are oversubscribed.
Increasing-rate debt	Short-term debt with an interest rate that increases by a specified amount each time the note is renewed.

In some cases, the embedded features may not be identified using the terminology in the above table, so the substance of the features should be carefully analyzed.

Further, often the debt or equity contract will contain multiple embedded features. Each feature needs to be separately analyzed for bifurcation.

9.3.40 Step 3: Determine the nature of the host contract

After identifying a contract as a hybrid instrument, it is necessary to identify the nature of the host contract; this is critical to analyzing whether an embedded feature requires separate accounting. The nature of the host contract will provide a reference point to evaluate whether the host and embedded features are clearly and closely related as discussed in Step 5 in section 9.3.60.

In certain circumstances, the identity of the host contract is evident from the nature of the hybrid instrument. For example, if a financial instrument host contract encompasses a residual interest in an entity, the economic characteristics and risks may be considered that of an equity instrument (equity host). In contrast, if the financial instrument host contract does not embody a claim on the residual interest in an entity, the economic characteristics and risks may be considered that of a debt instrument (debt host).

However, if a hybrid instrument is issued in the form of a share, the determination is made based on an evaluation of the overall nature and substance of the hybrid instrument.



Excerpt from ASC 815-15

> Applying the Clearly-and-Closely Related Criterion

25-17A For a hybrid financial instrument issued in the form of a share, an entity shall determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature on the basis of the relevant facts and circumstances. That is, in determining the nature of the host contract, an entity shall consider the economic characteristics and risks of the entire hybrid financial instrument including the embedded derivative feature that is being evaluated for potential bifurcation. In evaluating the stated and implied substantive terms and features, the existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. Although an individual term or feature may weigh more heavily in the evaluation on the basis of the facts and circumstances, an entity should use judgment based on an evaluation of all of the relevant terms and features. For example, an entity shall not presume that the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract, in and of itself, determines whether the nature of the host contract is more akin to a debt instrument or more akin to an

equity instrument. Rather, the nature of the host contract depends on the economic characteristics and risks of the entire hybrid financial instrument.

When an entity issues an equity instrument in the form of a share, it must determine if the share is more like a debt instrument or an equity instrument. This determination is necessary because the analysis of whether an embedded feature needs to be bifurcated differs depending on whether a host instrument is more like debt or equity.



Question 9.3.60

How does an entity determine if a share is more like debt or equity?

Interpretive response: An entity determines the nature of the share (i.e. the host contract) by considering all of its stated and implied substantive terms and features, weighing each term and feature on the basis of the relevant facts and circumstances. Further, it considers the economic characteristics and risks of the entire hybrid financial instrument, including the embedded feature being evaluated for potential bifurcation. [815-15-25-17A]

The existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. The analysis considers not only whether the relevant terms and features are debt-like versus equity-like, but also the substance of those terms and features. [815-15-25-17A, 17C]

It is not appropriate to disregard any provision or feature when analyzing the economic characteristics and risks of the host contract. This is because the instrument's cash flows ultimately depend on:

- the interaction of all contractual provisions in the instrument; and
- the way in which an investor or issuer may exercise options in the contract.

Subtopic 815-15 provides the following examples (not exhaustive) of common terms and features included in a hybrid financial instrument issued in the form of a share. The examples include the types of information and indicators that an entity (an issuer or a holder) should consider when assessing the substance of those terms and features in the context of determining the nature of the host contract. Having one of the features (or not having one) is not the sole factor in performing the analysis. [815-15-25-17D]

Feature	Description	Facts and circumstances to evaluate
Redemption rights [815-15-25-17D(a)]	The ability of an issuer or holder to redeem a hybrid financial instrument issued in the form of a share at a fixed or determinable price is generally viewed as a debt-like characteristic.	<ul style="list-style-type: none"> — Whether the redemption right is held by the issuer or holders — Whether redemption is mandatory — Whether redemption is non-contingent or contingent

Feature	Description	Facts and circumstances to evaluate
	<p>However, not all redemption rights are of equal importance. For example, a non-contingent redemption option may be given more weight in the analysis than a contingent redemption option.</p>	<ul style="list-style-type: none"> — Whether (and the degree to which) the redemption right is in-the-money or out-of-the-money — Whether there are any laws that restrict the issuer or holders from exercising the redemption right – e.g. laws prohibiting redemptions that would make the issuer insolvent — Issuer-specific considerations – e.g. whether the hybrid financial instrument is effectively the residual interest in the issuer due to the issuer being thinly capitalized or the common equity of the issuer having already incurred losses. Alternatively, the instrument may have been issued by a well-capitalized, profitable entity — If the hybrid financial instrument also contains a conversion right, the extent to which the redemption price is more or less favorable than the conversion price – i.e. a consideration of the economics of the redemption price and the conversion price – and not simply the form of the settlement on redemption or conversion
<p>Conversion rights [815-15-25-17D(b)]</p>	<p>The ability of an investor to convert (e.g. a preferred share into a fixed number of common shares), is generally viewed as an equity-like characteristic.</p> <p>However, not all conversion rights are of equal importance. For example, a conversion option that is non-contingent or deeply in-the-money may be given more weight in the analysis than a conversion option that is</p>	<ul style="list-style-type: none"> — Whether the conversion right is held by the issuer or holders — Whether conversion is mandatory — Whether the conversion right is non-contingent or contingent — Whether (and the degree to which) the conversion right is in-the-money or out-of-the-money — If the hybrid financial instrument also contains a redemption right held by the

Feature	Description	Facts and circumstances to evaluate
	contingent on a remote event or deeply out-of-the-money.	investor, whether conversion is more likely to occur before redemption – e.g. because of an expected IPO or change-of-control event before the redemption right becomes exercisable
Voting rights [815-15-25-17D(c)]	<p>The ability of a class of stock to exercise voting rights is generally viewed as an equity-like characteristic.</p> <p>However, not all voting rights are of equal importance. For example, voting rights that allow a class of stock to vote on all significant matters may be given more weight in the analysis than voting rights that are only protective in nature.</p>	<ul style="list-style-type: none"> — On which matters the voting rights allow the investor's class of stock to vote (relative to common stock shareholders) — How much influence the investor's class of stock can exercise as a result of the voting rights
Dividend rights [815-15-25-17D(d)]	The nature of dividends can be viewed as a debt-like or equity-like characteristic. For example, mandatory fixed dividends are generally viewed as a debt-like characteristic. In contrast, discretionary dividends based on earnings are generally viewed as an equity-like characteristic.	<ul style="list-style-type: none"> — Whether the dividends are mandatory or discretionary — The basis on which dividends are determined and whether the dividends are stated or participating — Whether the dividends are cumulative or noncumulative
Protective covenants [815-15-25-17(e)]	<p>Protective covenants are generally viewed as a debt-like characteristic.</p> <p>However, not all protective covenants are of equal importance. Covenants that provide substantive protective rights may be given more weight than covenants that provide only limited protective rights.</p>	<p>Whether there are any collateral requirements like collateralized debt</p> <p>If the hybrid financial instrument provides the holder with a redemption option, whether the issuer's performance on redemption is guaranteed by the parent of the issuer</p> <p>Whether the instrument provides the investor with certain rights that are like creditor rights – e.g. the right to force bankruptcy or a preference in liquidation</p>

For further discussion, see chapter 3 of KPMG Handbook, [Derivatives and hedging](#).



Question 9.3.70

Does a fixed-price, non-contingent redemption option held by the investor automatically result in a share being more like debt than equity?

Interpretive response: No. An entity considers the specific facts and circumstances of the transaction. It should not presume that a single feature like a fixed-price, non-contingent redemption option held by the investor determines whether the host contract is more like debt or equity.

For example, if an issuer lacks sufficient capital, it would be unable to redeem the instrument even if the investor exercised the redemption option. That would be true under various state laws and corporate charters under which a preferred share cannot be redeemed if it would cause the issuer to become insolvent.

Further, for private issuers of preferred shares, in some instances the issuer either:

- will perform well and have a liquidity event (whereby the conversion option would be exercised); or
- will perform poorly (whereby the preferred shareholders would effectively become the residual interest holders).

In both cases, the redemption option may not be exercised. Therefore, even with a redemption option, an investor may be exposed to the residual risks (i.e. negative movements) of an equity investment.



Question 9.3.75

Are convertible preferred equity certificate (CPECs) hybrid instruments issued in the form of shares?

Background: Convertible preferred equity certificates (CPECs) are generally issued by companies domiciled in Luxembourg. Although CPECs are termed ‘preferred equity certificates’, they are typically deemed legal-form debt in Luxembourg. Therefore, payments or accruals made under the CPECs are, similar to interest payments, deductible under local tax laws. However, for US taxation purposes, CPECs are treated as equity.

Interpretive response: Generally no, not if their legal form is debt in the jurisdiction of issuance. As discussed in Question 2.2.30, although CPECs are termed ‘preferred equity certificates’, we believe they generally should be classified as debt if they are deemed legal-form debt. In that situation and given all the typical features of a CPEC, we also believe CPECs represent debt instruments (not shares) when determining the nature of the host contract for analyzing whether embedded features require separate accounting.

9.3.50 Step 4: Determine if embedded feature is a derivative

For an embedded feature to be bifurcated and recorded separately, a freestanding instrument with the same terms as the embedded feature would have to meet the definition of a derivative instrument. Further, it would have to not fall in a scope exception to Topic 815. [815-15-25-1]

A derivative is a financial instrument that has all three of the following characteristics: [815-10-15-83]

- underlying, notional and/or payment provision;
- no or small initial net investment; and
- net settleable.

Each of these is discussed below and in more depth in chapter 2 of KPMG Handbook, [Derivatives and hedging](#).

Underlying, notional and/or payment provision

To meet the definition of a derivative, an embedded feature is required to have both an underlying and a notional amount/payment provision. An underlying cannot by itself determine the value or settlement of a derivative instrument. Such value or settlement is typically determined through the interaction between the changes in the underlying and the notional amount, which is the number of units specified in the contract. [815-10-15-83(a)]

Question 9.3.80
What are some examples of the underlying and notional amount/payment provision in a derivative?

Interpretive response: The following table provides examples of derivative instruments and their underlying and notional amount/payment provision. See chapter 6 for further discussion on these derivative instruments.

Instrument	Underlying	Notional amount or payment provision
\$10,000 interest rate swap to pay 7% interest and receive SOFR plus 300 basis points	SOFR	\$10,000 (notional amount)
Put option on 10,000 shares of Company A at \$10 per share	Price of Company A's shares	10,000 shares (notional amount)
Put option to pay \$15,000 if Company A's stock price falls below \$30 per share	Price of Company A's shares	\$15,000 (payment provision)
Contract that requires Company B to pay Company C \$10,000 if Company C does not	Occurrence or non-occurrence of the principal payment from Company D	\$10,000 (payment provision)

Instrument	Underlying	Notional amount or payment provision
receive a \$10,000 principal repayment from a loan it issued to Company D		

No or small initial net investment

To meet the definition of a derivative, an embedded feature is required to meet the initial net investment characteristic. It meets this characteristic if it has either: [815-10-15-83(b)]

- no initial net investment; or
- an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.



Question 9.3.90

Is the embedded derivative's initial net investment the same as the hybrid instrument's initial net investment?

Interpretive response: No. The embedded derivative's initial net investment is not the initial net investment for the hybrid instrument. Instead, conceptually the initial investment in the embedded derivative is the fair value of that derivative at the evaluation date – i.e. how much one would pay or receive to enter into the embedded derivative if it were a freestanding derivative. [815-15-25-1(c)]

For example, the conversion option in a convertible debt instrument results in a lower interest rate on the debt compared to debt that does not have a conversion option. The reduction in interest paid by the issuer related to the conversion option is still less than the initial investment required to purchase the underlying shares on a stand-alone basis, so it would meet the initial net investment characteristic.

Net settleable

To meet the definition of a derivative, an embedded feature is required to be net settleable. Net settlement can generally be defined as a one-way transfer of an asset (usually cash) from the counterparty in a loss position to the counterparty in a gain position. In contrast, gross settlement involves a two-way transfer, whereby Counterparty A transfers an asset (usually cash) to Counterparty B, and Counterparty B transfers an asset to Counterparty A. [815-10-15-83(c)]

Question 9.3.100

How does an embedded feature meet the net settlement criterion?

Interpretive response: To meet the net settlement criterion, the embedded feature generally must explicitly require or permit net settlement, be readily settleable net by a means outside the contract or put the receiving party in a position that is essentially equivalent to net settlement.

Net settlement can be accomplished in any of the following ways:

- through a **contractual net settlement**, which occurs when the terms of the contract require or permit net settlement;
- through a **market mechanism** that facilitates net settlement of the contract; or
- through delivery of an asset (i.e. **physical settlement**) that puts the recipient in a position not substantially different from net settlement.

These three net settlement methods allow an embedded feature to be net settled by any of the following means. [\[815-10-15-99\]](#)

<p>Contract terms implicitly or explicitly require or permit net settlement</p>	<p>Contractual net settlement occurs when neither party is required to deliver an asset:</p> <ul style="list-style-type: none"> — that is associated with the underlying; and — that has a principal amount, stated amount, par value, number of shares, or other denomination that is equal to the notional amount (or notional amount plus a premium or minus a discount). [815-10-15-100]
<p>Financial instrument can be readily settled by a means outside the contract</p>	<p>Net settlement outside the contract occurs when there is an established market mechanism that facilitates net settlement. For example, a contract might require delivery of an asset, but there is an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract. In this case, the net settlement criterion is met because there is a market mechanism that can facilitate net settlement. [815-10-15-110]</p>
<p>Contract is physically settled, but the asset is readily convertible to cash</p>	<p>For an asset to be considered readily convertible to cash, the following requirements must be met:</p> <ul style="list-style-type: none"> — the assets required to be delivered under the contract comprise interchangeable, fungible units; — quoted market prices are available for the assets to be delivered; and — the quantity to be delivered under the contract can be rapidly absorbed into an active market without significantly affecting the quoted price (e.g. shares of a publicly traded company – see also Question 9.3.130).



Question 9.3.110

Does a put or call option embedded in a debt host meet the net settlement criterion?

Interpretive response: Yes. The potential settlement of the debtor's obligation to the creditor upon exercise of a put option or call option meets the net settlement criterion. Upon exercise of a prepayment option, the debtor settles its own liability and that settlement should not be considered to involve the delivery of an asset. This conclusion applies regardless of whether the creditor returns evidence of the debtor's indebtedness (e.g. the creditor returns a note payable marked paid to the debtor), even though some may believe that the creditor is delivering an asset (i.e. the note receivable due from the debtor).

Further, the cash paid to the creditor in settling the debtor's obligation is not associated with the underlying (e.g. interest rates) because cash is not related to any underlying for the embedded put or call option. Therefore, neither party is required to deliver an asset that is associated with the underlying, so the net settlement criterion is met. [815-10-15-107]



Question 9.3.120

Does a put or call option embedded in an equity host meet the net settlement criterion?

Interpretive response: It depends. An entity is not permitted to analogize to the guidance discussed in Question 9.3.110 when evaluating an embedded put or call option in a hybrid instrument that does not contain a debt host contract. Therefore, that guidance does not apply unless the host contract is deemed to be more like a debt instrument than an equity instrument. [815-10-15-109(b)]

When a preferred share is deemed to be more like an equity instrument, the underlying share of preferred stock needs to be readily convertible to cash to meet the net settlement criterion (see Question 9.3.130).



Question 9.3.130

When are equity shares considered readily convertible to cash?

Interpretive response: The following table provides guidance on when a share is considered to be readily convertible to cash.

Share description	Readily convertible?
Actively traded	Generally, yes.
Not actively traded	Maybe. A security that is publicly traded but for which the market is not very active is readily convertible to cash if the number of shares or other units of the security under the contract is small relative to the daily transaction volume.

Share description	Readily convertible?
	That same security is not readily convertible to cash if the number of shares or other units of the security under the contract is large relative to the daily transaction volume – even if the purchaser can use the security as collateral in a borrowing. [815-10-15-130]
Not traded (nonpublic entity)	Generally, no.

The inability of a nonpublic entity to consider its own shares readily convertible to cash results in many embedded derivatives indexed to own shares failing the Subtopic 815-15 criteria for bifurcation.

Exceptions from derivative accounting

Even if a contract meets the definition of a derivative, it is not accounted for as a derivative if it meets one of the scope exceptions from derivative accounting in Subtopic 815-10. [815-10-15-13]



Question 9.3.140

What is the most common Subtopic 815-10 scope exception for embedded derivatives in debt and equity instruments?

Interpretive response: For debt and equity instruments, the scope exception that most frequently applies relates to contracts involving an entity's own equity. [815-10-15-13(k)]

The general principle behind that exception is that a contract issued or held by an entity should not be accounted for as a derivative if it is both: [815-10-15-74(a)]

- indexed to its own stock; and
- classified in stockholders' equity on its balance sheet.

This exception applies even if a separate instrument with the same terms as the embedded derivative would be classified as a liability or asset under Topic 480 but would be classified in stockholders' equity absent the provisions of Topic 480. [815-15-25-14]

The classification provisions of Topic 480 are disregarded when determining whether a separate instrument with the same terms as the embedded feature is a derivative instrument. [815-15-25-14]

For example, a freestanding written put option on an issuer's own shares is in the scope of Topic 480, regardless of the settlement method. However, a written put option embedded in an issuer's own shares is not in the scope of Topic 480. Instead, the issuer is required to determine whether that embedded written put option should be separated under the provisions of Topic 815. When making that determination, the issuer does not look to the classification guidance in Topic 480 to determine whether an embedded feature would be a derivative instrument subject to the requirements of Topic 815.

For further guidance on determining if a contract indexed to an entity's own stock meets the own equity scope exception from derivative accounting, see chapter 8.

As illustrated in Example 9.3.10, other scope exceptions from derivative accounting can apply.



Question 9.3.150

Is an embedded purchased call option indexed solely to an issuer's own stock a derivative?

Interpretive response: Typically no. An embedded purchased call option that allows the equity instrument's issuer to reacquire the instrument would not be considered a derivative by the issuer provided that it is indexed solely to the issuer's own stock and classified in stockholders' equity on its balance sheet (see Question 9.3.140).

Therefore, the issuer does not bifurcate such an embedded purchased call option from its equity host contract. [815-15-25-20]



Example 9.3.10

Loan agreement that provides a return based on successful sales of the borrower's product

Issuer has several products under development. It obtains financing for a new developmental pharmaceutical product from Lender. Issuer does not make any payment to Lender at the time of entering into the lending arrangement.

The lending arrangement provides Lender with an enhanced return in the event that the product is successful and generates sales. Specifically, if Issuer is able to sell a minimum level of the specified product, Lender receives double the principal amount of the loan at maturity. Lender will receive three times the principal amount if a higher threshold of sales related to the product is achieved. The enhanced return on the loan is only in relation to the specific sales of an individual product, and not Issuer's aggregate sales.

Is the embedded feature a derivative?

This embedded feature (which provides Lender an enhanced return) qualifies as a derivative because it has:

- a payment provision (two times principal, three times principal);
- an underlying (the contingent event, sale of the product);
- an initial net investment lower than would be required for other similar contracts that would be expected to have a similar response to the contingent event; no cash was exchanged at inception; and
- a provision allowing for net settlement in cash when Issuer makes the payment to Lender.

Do any scope exceptions from derivative accounting apply?

Issuer then evaluates the embedded derivative to determine if it qualifies for any of the scope exceptions from derivative accounting. Issuer determines that the scope exception in paragraph 815-10-15-59(d) applies because the contract is not exchange traded and the underlying is based on specified volumes of Issuer's sales.

Note: The non-exchange traded scope exception in paragraph 815-10-15-59(d) does not require the contract to be based on Issuer's aggregate sales. One of the primary reasons for this scope exception is to exclude a lease contract with certain payments based on sales volumes specifically related to the leased property. It is not appropriate to assume that to qualify for this scope exception the sales volume would be an aggregate measure and not specific to the leased property. Therefore, the scope exception is not limited to circumstances in which the payment provision is based on an entity's aggregate sales, but also applies when it is based on the sales of an individual product.

9.3.60 Step 5: Apply the 'clearly and closely related' criterion

The last step in the five-step decision sequence is to determine if the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. If they are, the embedded derivative is not bifurcated. [815-15-25-1(a)]



Question 9.3.160

When are the economic characteristics and risks of an embedded derivative clearly and closely related to those of the host contract?

Interpretive response: The economic characteristics and risks of an embedded derivative and its host contract are clearly and closely related if the underlying that causes the value of the embedded derivative to fluctuate is related to the inherent economic nature of the host instrument. [815-15-25-1(a)]

Determining whether an embedded derivative and the host contract are clearly and closely related requires judgment. The interdependency between the two may help to indicate whether the embedded derivative is clearly and closely related to its host contract. An embedded derivative that has a fair value commonly associated with the fair value of the host contract will often be clearly and closely related to that host contract.

For example, the fair value of a prepayment option embedded in callable debt is directly affected by the fair value of the debt instrument in which it is embedded. Therefore, a non-contingent embedded prepayment option generally is clearly and closely related to the interest rate on the debt host.

In contrast, the fair value of the embedded derivative in an equity-indexed debt instrument that pays the holder a return based on increases in the S&P 500

Index is not directly affected by the interest rate on the debt host in which it is embedded. Therefore, the embedded derivative is not considered to be clearly and closely related to the interest rate on the debt host.

The analysis of the 'clearly and closely related' criterion differs when the host contract has equity characteristics versus when it has debt characteristics, as explained in the remainder of this section.

Host contracts with equity characteristics



Excerpt from ASC 815-15

> Applying the Clearly-and-Closely Related Criterion

25-16 If the host contract encompasses a residual interest in an entity, then its economic characteristics and risks shall be considered that of an equity instrument and an embedded derivative would need to possess principally equity characteristics (related to the same entity) to be considered clearly and closely related to the host contract.

Under the general principle stated in Question 9.3.160, an embedded feature is clearly and closely related to its host contract if the embedded feature's underlying is related to the inherent economic nature of the host contract. This means that if the host contract has equity characteristics, an embedded derivative is clearly and closely related to the host contract when it possesses principally equity characteristics related to the issuing entity. [815-15-25-16]



Question 9.3.170

How does an entity determine whether an embedded derivative is clearly and closely related to an equity host contract?

Interpretive response: The value of an equity host contract is primarily driven by the value of the issuing entity's equity. Therefore, an embedded derivative is clearly and closely related to the equity host contract when it possesses principally equity characteristics related to the issuing entity. If the underlying of the embedded derivative is associated with the index or price of a different entity's equity, the embedded derivative component is not clearly and closely related to the equity host contract. [815-15-25-16]

If the embedded derivative is not clearly and closely related, the other steps in this chapter need to be evaluated to determine whether an entity should bifurcate the embedded derivative.

**Question 9.3.180****Is a cash-settled embedded put option clearly and closely related to an equity host contract?**

Interpretive response: No. Certain equity instruments enable the holder to require the instrument's issuer to reacquire the instrument for cash. This right represents an embedded put option written by the instrument's issuer to the instrument's holder. Because the put option is to be settled in cash, it is not clearly and closely related to the equity host contract from both the holder's and issuer's perspectives. [815-15-25-20]

Because the embedded derivative is not clearly and closely related, the other steps in this chapter need to be evaluated to determine whether an entity should bifurcate the embedded put option.

**Question 9.3.190****What are other examples of embedded features in equity hosts?**

Interpretive response: The following are examples of other terms in equity host contracts and an evaluation of whether they are clearly and closely related to the equity host contracts.

Example	Clearly and closely related?
Rights offering features	<p>Rights offering features may be embedded in shares and provide shareholders with the right to purchase additional shares of the issuer at the then-current fair value.</p> <p>Embedded rights offering features encompass a residual equity interest in the issuer and are generally clearly and closely related to the equity host contract.</p>
Indexed dividends	<p>The dividend rate on some preferred shares may be variable and tied to an external index. The specific facts and circumstances are considered in evaluating indexed dividends for bifurcation.</p> <p>There are two views in analyzing whether the indexed dividend is clearly and closely related to the underlying preferred shares.</p> <p>Under the first view, advance selection of the method of calculating the amount of dividend to be distributed should not result in the indexed dividend being not clearly and closely related to the equity host.</p> <p>Under another view, because the dividend is tied to an external index, the embedded feature is not clearly and closely related to the equity host.</p>

Example	Clearly and closely related?
	We generally believe that dividends indexed to a benchmark interest rate like SOFR or US Treasury may be considered clearly and closely related to the host preferred shares.

Host contracts with debt characteristics

Applying the 'clearly and closely related' criterion when the host contract has debt characteristics generally is straightforward (see Question 9.3.200), unless:

- the embedded derivative's underlying is interest rate related and introduces leverage (see Question 9.3.210); or
- the embedded derivative is a put or call option (see Questions 9.3.220 and 9.3.230).



Question 9.3.200

When is an embedded derivative clearly and closely related to a debt host contract?

Interpretive response: Under the general principle stated in Question 9.3.160, an embedded derivative is clearly and closely related to its host contract if the embedded derivative's underlying is related to the inherent economic nature of the host contract. Generally, a debt instrument's embedded derivative is clearly and closely related to the debt host contract when the embedded derivative's underlying is linked to interest rates, inflation, or the creditworthiness of the host contract's issuer (i.e. the debtor or borrower).

The value of a debt instrument is driven by the associated interest rate. The interest rate of a debt instrument comprises a risk-free rate adjusted for expectations and risks related to:

- future inflation during the term of the debt instrument (i.e. possible changes in the purchasing power of money);
- the possibility that the invested funds may not be fully recovered (i.e. creditworthiness of the debtor); and
- liquidity risk (i.e. longer term maturities are viewed to have more liquidity risk than shorter term maturities).

An embedded derivative is not separated from the host contract for debt instruments that have the interest rate reset in the event of: [\[815-15-25-46\]](#)

- debtor's default (e.g. violation of a credit-risk-related covenant);
- a change in the debtor's published credit rating; or
- a change in the debtor's creditworthiness indicated by a change in its spread over Treasury bonds.

This is because the debtor's creditworthiness is clearly and closely related to the host debt instrument. However, if the embedded derivative incorporates credit risk exposures that are unrelated or only partially related to the

creditworthiness of the issuer of the instrument, it is not clearly and closely related.

Certain debt arrangements include collateral that is pledged to the creditors. If the debtor does not make payments due under the arrangement, the creditor has recourse solely to that collateral and not to the debtor (i.e., nonrecourse debt arrangements). Those arrangements are not considered to include credit risk exposure unrelated to, or only partially related to, the debt's issuer.

Additional provisions apply when the underlying is interest related and potentially provides leverage to the holder (see Question 9.3.210).



Question 9.3.210

Is an embedded derivative with only an interest rate related underlying always considered clearly and closely related to a debt host contract?

Interpretive response: No. Most embedded derivatives that are interest rate related are clearly and closely related to a debt host contract, including floors, caps and collars. However, an interest-rate underlying that introduces leverage causes the embedded derivative to not be clearly and closely related to the debt host contract. An interest related underlying can take the form of either an interest rate or an interest rate index.

Subtopic 815-15 describes two conditions in which an embedded derivative's underlying introduces leverage, causing the embedded derivative to not be clearly and closely related to the debt host contract. This guidance applies to embedded derivatives with a single interest rate or interest rate index underlying that can alter net interest payments that would otherwise be paid or received on a debt host contract. However, the guidance does not apply to embedded derivatives containing an underlying other than a single interest rate or interest rate index underlying or multiple underlyings (e.g. dual-indexed options).

Condition 1: Holder may not recover entire investment

An embedded derivative's underlying introduces leverage when the hybrid debt instrument can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment. However, this condition does not apply when the investor is permitted (but not required) to settle the instrument in this manner – e.g. an investor held put option on the debt instrument. [815-15-25-26(a), 25-29]

Condition 2: Double-double test

An embedded derivative's underlying introduces leverage when the following two conditions (called the double-double test) are met: [815-15-25-26(b)]

- there is a possible future interest rate scenario under which the embedded derivative would at least double the investor's initial rate of return on the host contract; and
- for any possible future interest rate scenario, the embedded derivative would also result in a rate of return that is at least twice what otherwise

would be the then-current market return for a contract that has the same terms as the host contract.

When the issuer of the debt holds a call option that only it can exercise, it does not need to apply the double-double test because the investor does not have the right to receive the high rate of return. However, the issuer would still need to evaluate the call option under Condition 1 to determine if the option results in the investor not recovering substantially all of its initial recorded investment based on its contractual terms. [815-15-25-37]

For further discussion on application of this test, see chapter 3 of KPMG Handbook, [Derivatives and hedging](#).



Example 9.3.20

'Clearly and closely related' criterion applied to a structured note

Debtor purchases for \$10 million a structured note with a par value of \$10 million, a coupon of 9% and a term of two years. The note's terms require that if the interest rate for single-A-rated debt decreases to 5% while the note is outstanding, the principal amount on the note is reduced to \$7.5 million.

If the interest rate for single-A-rated debt decreases to 5% immediately after issuance of the structured note, the undiscounted net cash inflows received by the investor over the two-year life of the instrument would be \$8.85 million (\$7.5 million principal and \$1.35 million interest on the principal at the coupon rate of 9% for 2 years) and the investor would not recover 11.5% (\$1.15 million) of its \$10 million initial recorded investment.

The debt instrument can contractually require settlement in such a way that the investor (holder) would not recover substantially all of its initial recorded investment. Therefore, Condition 1 in Question 9.3.210 is present, and the embedded derivative instrument is not considered to be clearly and closely related to the host contract.



Example 9.3.30

'Clearly and closely related' criterion applied to variable-rate debt with a floor

Investor holds a bond with a coupon rate of interest that varies with changes in an interest rate index (SOFR). Investor receives interest based on SOFR; however, if the SOFR rate falls below 2% at any reset date, Investor receives 2%. Issuer could have issued a bond at par without an embedded floor at SOFR plus 1%. At the date of issuance, SOFR is 1.5%. The bonds are issued at par and Investor paid par.

There are no contractual provisions that would allow the debt to be settled so that Investor would not recover substantially all of its initial recorded investment. Therefore, Condition 1 in Question 9.3.210 is not present.

Issuer must perform the double-double test (Condition 2 in Question 9.3.210). Debt without a floor could have been issued at par for SOFR plus 1%; consequently, the initial rate of return on the host contract is 2.5%. Further, Investor is guaranteed a rate of return throughout the life of the hybrid instrument of at least 2%. Therefore, there is no possibility that the embedded floor would double Investor's initial rate of return on the host contract; the embedded floor would have to guarantee a rate of return of at least 5% to meet this condition. As such, Condition 2 is not present, and the embedded derivative instrument is considered to be clearly and closely related to the host contract.



Example 9.3.40

'Clearly and closely related' criterion applied to a callable fixed-rate debt

Investor purchases a four-year, 2.5% fixed-rate debt instrument for its par value of \$1,000 on the day it is issued. The debt instrument is callable by Issuer at \$1,025 at any time.

Issuer could have issued the following instruments:

- a noncallable four-year fixed-rate debt instrument issued at par with a rate of 2%; and
- a noncallable four-year variable-rate debt instrument issued at par based on SOFR. At the date of issuance, SOFR is 2%.

The hybrid instrument can be viewed as containing a 2%, fixed-rate host with an embedded call option.

There are no contractual provisions that would allow the debt to be settled so that Investor would not recover substantially all of its initial recorded investment. Therefore, Condition 1 in Question 9.3.210 is not present.

The embedded call option has a single interest rate underlying and is exercisable only by Issuer. Therefore, Issuer does not need to apply the double-double test because Investor does not have the right to receive the high rate of return – i.e. Condition 2 in Question 9.3.210 is not present.

Because the provisions of Subtopic 815-15 are not met, the embedded call option with a single interest rate underlying is considered clearly and closely related to the debt host.



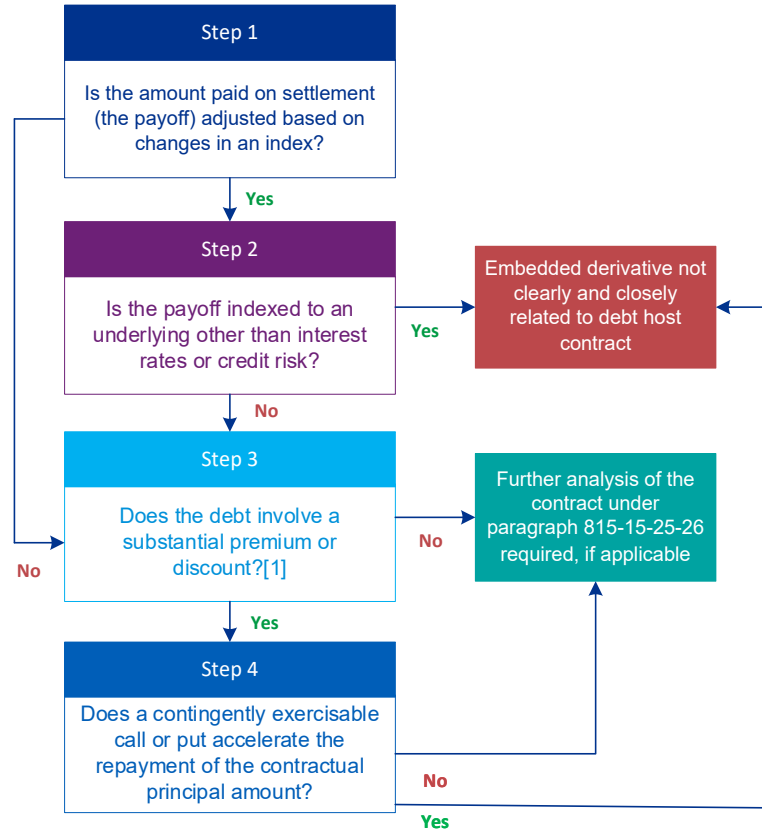
Question 9.3.220

How are put and call options embedded in debt instruments analyzed under the 'clearly and closely related' criterion?

Interpretive response: Prepayment options (call options and put options) on a debt instrument typically allow for the accelerated repayment of the principal amount of the debt instrument. If they do not allow accelerated repayment of the principal amount, but instead require a cash settlement equal to the option

price on the exercise date, they are not clearly and closely related to the host debt contract. [815-15-25-41]

When a put or call option can accelerate settlement of a debt instrument, Subtopic 815-15 provides a four-step decision sequence to determine whether the option is clearly and closely related to the debt host contract. [815-15-25-42]



Note 1. We believe that a substantial premium or discount should be interpreted as a premium or discount that is 10% or greater of the amount allocated to the hybrid instrument when the instrument is originally recognized, compared to its payoff amount. Further, a substantial premium or discount may arise at a time other than when the debt is issued. For example, debt issued at par but puttable at 115% of par involves a substantial discount. However, we do not believe that a discount created solely through the separate accounting for an embedded derivative feature should be considered in the evaluation. Under this view, the assessment of whether the debt has a substantial premium or discount is effectively evaluated before separating the hybrid debt instrument into different units of account. Finally, we believe a put or call option that requires a debt instrument to be repaid at its accreted value is generally not considered to involve a substantial discount or premium.

Put or call options with a single underlying

An option with a single underlying typically is clearly and closely related to the interest rate on the debt host contract because interest rates include an adjustment for expectations and risks related to liquidity. Specifically, although put or call options are sometimes exercised without regard to actual changes in interest rates, Subtopic 815-15 requires the underlying in all put or call options embedded in debt host contracts to be considered an interest rate underlying.

Because changes in interest rates are considered clearly and closely related to a debt host contract, the embedded put or call option typically is considered clearly and closely related to the debt host contract.

Nevertheless, the four-step decision sequence discussed above needs to be applied to all put and call options with a single underlying. There are circumstances in which a put or call option with a single interest rate or interest rate index underlying is not clearly and closely related to the debt host (see Question 9.3.210).

Put or call options with multiple underlyings

Put or call options embedded in debt instruments may contain multiple underlyings and include features such as indexed payoffs (instead of a simple acceleration of the redemption amount). Alternatively, they may be contingently exercisable instead of exercisable after a period of time – e.g. upon the occurrence of a change in control.

If either Steps 3 or 4 in the decision sequence are considered but do not apply, the decision tree indicates that further analysis is required under paragraph 815-15-25-26 to determine whether the embedded put or call option is clearly and closely related to the debt host contract.

The wording in Steps 3 and 4 implies that any embedded put or call option would require evaluation under paragraph 815-15-25-26 before concluding that the option is clearly and closely related to a debt host. However, paragraph 815-15-25-26 provides guidance on an embedded feature instrument in which the **only** underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract. Therefore, paragraph 815-15-25-26 is not intended to apply to put or call options that contain multiple underlyings. This means the evaluation of whether an embedded put or call option containing multiple underlyings is clearly and closely related to a debt host contract would be completed after the above decision sequence. In contrast, an embedded put or call option containing a single, interest rate underlying would need to be further analyzed under paragraph 815-15-25-26 after steps 3 and 4 are completed.

Contingent put or call options:

We believe the four-step decision sequence provides the entire framework for determining whether a contingent put or call is clearly and closely related to its debt host contract. Specifically, there is no need to separately evaluate the contingency under paragraph 815-15-25-26 to determine whether the contingency itself is indexed only to interest rates or credit risk and not some extraneous factor.



Example 9.3.50

Applying decision sequence to puttable debt

Issuer issues debt at a substantial premium that is puttable by Investor (the creditor) at any time for its par value.

Because the embedded put option in this example contains a single interest rate underlying, Issuer concludes that the option is clearly and closely related to

the debt host contract. Its conclusion is based on the four-step decision sequence (see Question 9.3.220), which it performs as follows.

Step 1	The amount paid on settlement is the par value of the debt, so the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1 is 'no' and the analysis proceeds to Step 3.
Step 3	The debt involves a substantial premium, so the answer to Step 3 is 'yes' and the analysis proceeds to Step 4.
Step 4	Because the put option is not contingently exercisable, further analysis is required under the provisions related to interest rate underlyings in paragraph 815-15-25-26.

Under paragraph 815-15-25-26, the put option is not clearly and closely related to the debt host contract if it satisfies one of two conditions (see Question 9.3.210).

Condition 1: Holder may not recover entire investment

The first condition is that the hybrid instrument can contractually be settled in such a way that Investor would not recover substantially all of its initial recorded investment.

In this example, the hybrid instrument could be settled in a manner such that Investor would not recover substantially all of its initial recorded investment – i.e. if the debt, which was issued at a substantial premium, is put back to Issuer for par shortly after issuance. However, this first condition is not met because the terms of the hybrid instrument permit but do not require Investor to settle in a manner that it does not recover substantially all of its initial recorded investment.

Condition 2: Double-double test

The second condition is not met because there are no contractual provisions that would allow the debt to be settled so that Investor's initial rate of return:

- would be double the return on the host contract; and
- would result in a rate of return that is at least twice the then-current market rate for the host contract.

Conclusion

The four-step decision sequence (which includes an analysis of paragraph 815-15-25-26) does not indicate that the embedded put option is not clearly and closely related to the debt host contract. Therefore, it is not bifurcated from the debt host contract.



Example 9.3.60

Applying decision sequence to callable debt

Issuer issues debt at a substantial discount that it may call at any time for par value.

Because the embedded call option contains a single interest rate underlying, Issuer concludes that the option is clearly and closely related to the debt host

contract. Its conclusion is based on the four-step decision sequence (see Question 9.3.220), which it performs as follows.

Step 1	The amount paid on settlement is the par value of the debt, so the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1 is 'no' and the analysis proceeds to Step 3.
Step 3	The debt involves a substantial discount, so the answer to Step 3 is 'yes' and the analysis proceeds to Step 4.
Step 4	Because the call option is not contingently exercisable, further analysis is required under the provisions related to interest rate underlyings in paragraph 815-15-25-26.

Issuer evaluates the call option under paragraph 815-15-25-26:

- there are no contractual provisions that would allow the debt to be settled so that Investor (the creditor) would not recover substantially all of its initial recorded investment; therefore, the first condition in paragraph 815-15-25-26 is not met; and
- the embedded call option is exercisable only by Issuer; therefore, the second condition in paragraph 815-15-25-26 does not apply (see Question 9.3.210).

The four-step decision sequence (which includes an analysis of paragraph 815-15-25-26) does not indicate that the embedded call option is not clearly and closely related to the debt host. Therefore, it is not bifurcated from the debt host contract.



Example 9.3.70

Applying decision sequence to contingently puttable debt

Issuer issues debt at a substantial discount that is puttable at par if SOFR either increases or decreases by 150 basis points.

The embedded put option in this example has multiple underlyings (interest rates and the occurrence or nonoccurrence of a specified change in an interest rate index). It is evaluated under the four-step decision sequence (see Question 9.3.220), as follows.

Step 1	The amount paid on settlement is the par value of the debt, so the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1 is 'no' and the analysis proceeds to Step 3.
Step 3	The debt involves a substantial discount, so the answer to Step 3 is 'yes' and the analysis proceeds to Step 4.
Step 4	Because the put option is contingently exercisable, the embedded put option is not considered clearly and closely related to the debt host and is bifurcated.

**Example 9.3.80****Applying decision sequence to contingently callable debt**

Issuer issues debt at a substantial discount that is callable at par if SOFR either increases or decreases by 150 basis points.

The embedded call option in this example has multiple underlyings (interest rates and the occurrence or nonoccurrence of a specified change in an interest rate index). It is evaluated under the four-step decision sequence (see Question 9.3.220), as follows.

Step 1	The amount paid on settlement is the par value of the debt, so the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1 is 'no' and the analysis proceeds to Step 3.
Step 3	The debt involves a substantial discount, so the answer to Step 3 is 'yes' and the analysis proceeds to Step 4.
Step 4	Because the call option is contingently exercisable, the embedded call option is not considered clearly and closely related to the debt host and is bifurcated.

Investor (the creditor) does not have the unilateral ability to obtain the right to receive the increased rate of return because exercise of the call option is solely at the option of Issuer. However, the embedded call option in this example is not clearly and closely related to the debt host based on the four-step decision sequence, so it is not relevant whether the right to accelerate settlement of the debt can be exercised only by Issuer. Specifically, the guidance in paragraph 815-15-25-26(b) does not apply because the embedded call option in this example has multiple underlyings.

**Example 9.3.90****Applying decision sequence to contingently callable zero-coupon debt**

Issuer issues zero-coupon debt that is callable in the event of a change in control. If the debt is called, Issuer pays the accreted value – calculated per an amortization table based on the effective interest method.

The embedded call option has multiple underlyings (interest rates and the occurrence or nonoccurrence of a change in control) and is evaluated under the four-step decision sequence (see Question 9.3.220), as follows.

Step 1	The amount paid on settlement is the accreted value of the debt, so the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1 is 'no' and the analysis proceeds to Step 3.
Step 3	The debt involves a substantial discount, so the answer to Step 3 is 'yes' and the analysis proceeds to Step 4.

Step 4

Although the call option is contingently exercisable, the call option does not accelerate the repayment of the contractual principal amount because the debt is callable at the accreted value. Because the call option has multiple underlyings, further evaluation under paragraph 815-15-25-26 is not required.

As a result, the embedded call option is clearly and closely related to the debt host under the four-step decision sequence in paragraph 815-15-25-41 and therefore is not bifurcated.

**Example 9.3.100****Applying decision sequence to debt with indexed call option**

Issuer issues debt at par that is callable at any time during its term. If the debt is called, Investor (the creditor) receives the greater of the par value of the debt or the market value of 100,000 DEF Corp. common shares (an unrelated company).

The embedded call option has multiple underlyings (interest rates and DEF's share price). It is evaluated under the four-step decision sequence (see Question 9.3.220), as follows.

Step 1

The amount paid on settlement may be adjusted based on changes in an index (the equity price of DEF's common shares). As a result, the answer to Step 1 is 'yes' and the analysis proceeds to Step 2.

Step 2

The amount paid on settlement is indexed to an underlying other than interest rates or credit risk (the equity price of DEF's common shares). As a result, the call option is not considered clearly and closely related to the debt host and is bifurcated.

Investor does not have the unilateral ability to obtain the right to receive the increased rate of return because exercise of the call option is solely at the option of Issuer. However, the embedded call option is not clearly and closely related to the debt host contract based on an analysis of the first two steps of the four-step decision sequence. Therefore, it is not relevant whether the right to accelerate settlement of the debt can be exercised only by Issuer – i.e. the guidance in paragraph 815-15-25-26(b) does not apply because the embedded call option has multiple underlyings.

**Example 9.3.110****Applying decision sequence to debt with indexed put option**

Issuer issues debt at par that is puttable at any time during its term. If the debt is put, Investor (the creditor) receives the lesser of (1) the par value of the debt adjusted for the percentage change in the S&P 500 or (2) the par value of the debt.

The embedded put option in this example has multiple underlyings (interest rates and the S&P 500, an equity index). It is evaluated under the four-step decision sequence (see Question 9.3.220), as follows.

Step 1	The amount paid on settlement may be adjusted based on changes in an index (the S&P 500, an equity index). As a result, the answer to Step 1 is 'yes' and the analysis proceeds to Step 2.
Step 2	The amount paid on settlement is indexed to an underlying other than interest rates or credit risk (the S&P 500, an equity index). As a result, the put option is not considered clearly and closely related to the debt host and is bifurcated.

The exercise of the put option is solely at Investor's option. However, the embedded put option is not clearly and closely related to the debt host contract based on an analysis of the first two steps of the four-step decision sequence. Therefore, it is not relevant whether the right to accelerate settlement of the debt can be exercised only by Investor – i.e. the guidance in paragraph 815-15-25-26(a) does not apply because the embedded put option in this example has multiple underlyings.



Example 9.3.120

Applying decision sequence to debt that becomes callable upon the price of gold exceeding a pre-set price

Issuer issues debt at par (\$100) that is callable at \$107 if the price of gold is greater than \$1,700 per ounce.

The embedded call option in this example has multiple underlyings (interest rates and the price of gold) and is evaluated under the four-step decision sequence (see Question 9.3.220), as follows.

Step 1	The amount paid by Issuer on settlement includes a premium above par; however, the amount of the premium is not adjusted based on changes in the price of gold. As a result, the answer to Step 1 is 'no' and the analysis proceeds to Step 3.
Step 3	The payoff of the debt under the call does not involve a substantial discount or premium because the \$7 difference between the call price and the par value of the debt is not considered to be a substantial premium. Therefore, the analysis does not proceed to Step 4 and further consideration under paragraph 815-15-25-26 is not required. There is also no need to separately evaluate whether the contingency itself is indexed only to interest rates or credit risk, and not to some extraneous factor.

Paragraph 815-15-25-26 is not intended to apply to put or call options that contain multiple underlyings – e.g. contingently exercisable options and options containing an indexed payoff. Because the embedded call option in this example has multiple underlyings, the evaluation of whether it is clearly and closely related to a debt host contract is completed after the above decision

sequence. The embedded call option is considered clearly and closely related to the debt host and is not bifurcated.



Question 9.3.230

How is a debt instrument considered when it has an embedded call and put option with the same terms and the same underlying?

Background: Certain instruments contain an embedded call and put option executed contemporaneously with the same counterparty as part of a single hybrid instrument. The call and put have the same terms (strike price, notional amount and exercise date) and the same underlying. Further, they cannot be separated from the hybrid instrument. When those conditions exist, the embedded options are considered as a single forward contract when applying Subtopic 815-15. [\[815-10-25-10\]](#)

Interpretive response: Those embedded call and put options are in substance an embedded forward contract because they: [\[815-10-25-11\]](#)

- convey rights and obligations that are equivalent from an economic and risk perspective to an embedded forward contract; and
- cannot be separated from the hybrid instrument in which they are embedded.

Even though neither party is required to exercise its option, the result of the overall structure is a hybrid instrument that will likely be redeemed earlier than its stated maturity. That result is expected by both the hybrid instrument's issuer and investor regardless of whether the embedded features that trigger redemption are in the form of two options or a single forward contract. [\[815-10-25-12\]](#)

In that circumstance, the counterparties to the hybrid instrument have agreed to terms that accelerate the stated maturity of the instrument so that the exercise date of the option is essentially the hybrid instrument's actual maturity date for accounting purposes. [\[815-10-25-12\]](#)

However, if either party is required to exercise its purchased option before the stated maturity date of the hybrid instrument, the hybrid instrument should not be viewed as containing an embedded forward contract or embedded put and call options. [\[815-10-25-13\]](#)



Example 9.3.130

Debt instruments issued with put and call options

Issuer issues fixed-rate debt that has a stated maturity of December 31, Year 5. The debt contains an option that allows Investor to put the debt to Issuer at par on December 31, Year 3. The debt also contains an option that allows Issuer to call the debt from Investor at par on December 31, Year 3. Therefore, the debt instrument contains a combination of embedded options.

This combination of embedded options is considered a single forward contract for purposes of applying the provisions of Subtopic 815-15 because the options have:

- the same terms: the strike price is par, the notional amount is equal to the par value of the debt and the exercise date is December 31, Year 3; and
- the same underlying (changes in interest rates).



Question 9.3.240

Is an embedded conversion option considered clearly and closely related to a convertible debt instrument?

Interpretive response: No. Convertible debt instruments are those debt instruments that are convertible into common shares of the issuer. The conversion feature of such instruments is an embedded call option that permits the investor to obtain the issuer's shares by relinquishing the debt. Changes in the fair value of an equity interest are not clearly and closely related to a debt host contract. However, further analysis is required – including whether the conversion option qualifies for the own equity scope exception (see Question 9.3.140) – to determine whether it needs to be bifurcated. [815-15-25-51]



Question 9.3.245**

Is an embedded feature that provides a cash payment to the holder if the issuer pays dividends on its common stock considered clearly and closely related to a convertible debt instrument?

Interpretive response: No. As discussed in Question 9.3.200, generally an embedded derivative is clearly and closely related to a debt host contract when the embedded derivative's underlying is linked to interest rates or the creditworthiness of the host contract's issuer. In contrast, dividends on common shares impact the value of the issuer's equity. Therefore, an embedded feature that provides a cash payment to the convertible debt holder if the issuer pays dividends on its common stock is a contingent feature whose underlying is not linked to either interest rates or creditworthiness of the convertible debt instrument's issuer and is not clearly and closely related to the convertible debt instrument. This is the case even if the amount of additional interest paid is equal to the amount of dividends the holder would have received if it had already converted the debt instrument into common shares. Such a feature would typically meet the definition of a derivative if it is freestanding and requires bifurcation from the convertible debt instrument.

However, if the instrument does not make a cash payment to the convertible debt holder but instead adjusts the conversion option's terms upon an issuer payment of dividends on its common shares, further analysis is needed to determine whether bifurcation of the conversion option is required. This further analysis includes determining whether the conversion option meets the

definition of a derivative (see section 9.3.50) and/or qualifies for the own equity scope exception (see Question 9.3.140). [815-15-25-1, 25-51]

Question 9.3.250

What are other examples of embedded features in debt hosts?

Interpretive response: The following table provides examples of other terms in debt host contracts and the evaluation of whether they are clearly and closely related to a debt host contract.

Example	Clearly and closely related?
Term-extending option	<p>No, unless the interest rate is concurrently reset to approximately the current market rate for the extended term and the debt instrument initially involved no significant discount. [815-15-25-44 to 25-45]</p> <p>Although not clearly and closely related, a term-extending option frequently is not bifurcated as an embedded derivative. For example, it may represent a loan commitment that qualifies for a scope exception from derivative accounting (see KPMG Handbook, Derivatives and hedging, Question 2.11.20). Or, it may not meet the net settlement characteristic – and, therefore, not meet the definition of a derivative – because the only way its value can be realized is through a structured payout (see KPMG Handbook, Derivatives and hedging, section 3.5.20).</p>
Interest rate reset due to change in creditworthiness of issuer	<p>Yes. The creditworthiness of the debtor and the interest rate on a debt instrument are considered to be clearly and closely related.</p> <p>Therefore, for a debt instrument that has the interest rate reset in the event of any of the following conditions, the related embedded derivative is considered clearly and closely related to the debt host: [815-15-25-46]</p> <ul style="list-style-type: none"> — default (e.g. violation of a credit-risk-related covenant); — a change in the debtor’s published credit rating; or — a change in the debtor’s creditworthiness indicated by a change in its spread over US Treasury bonds.
Interest rate reset due to change in creditworthiness of third party	<p>No. An instrument may incorporate a credit risk exposure that is based on a default or change in creditworthiness of an entity other than the obligor (i.e. a third party).</p> <p>In this case, the economic characteristics and risks of the embedded credit derivative are not clearly and closely related to the economic characteristics</p>

Example	Clearly and closely related?
	and risks of the host contract, even though the obligor may own securities issued by the third party. [815-15-25-47]
Commodity-indexed interest or principal payments	<p>No. The changes in fair value of a commodity (or other asset) and the interest yield on a debt instrument are not clearly and closely related. Therefore, a commodity-related derivative instrument embedded in a commodity-indexed debt instrument is not clearly and closely related to the debt host. [815-15-25-48]</p> <p>However, if the embedded commodity contract would have been eligible to qualify for the normal purchases and normal sales scope exception if it had been a separate contract, it is not separately accounted for by the party to whom it is a normal purchase or normal sale (see KPMG Handbook, Derivatives and hedging, section 2.4.10).</p>
Equity-indexed interest payments	<p>No. The changes in fair value of an equity interest and the interest yield on a debt instrument are not clearly and closely related. Therefore, an equity-related derivative embedded in an equity-indexed debt instrument is not clearly and closely related to the debt host. This is the case whether the embedded derivative is based on the price of a specific common stock or on an index that is based on a basket of equity instruments. [815-15-25-49]</p> <p>However, if the embedded equity-indexed component qualifies for the own equity scope exception from derivative accounting, it is not separately accounted for; see Question 9.3.140.</p>
Inflation-indexed interest payments	<p>It depends on whether the inflation-indexed feature is leveraged or nonleveraged. The interest rate and the rate of inflation in the economic environment for the currency in which the debt instrument is denominated are considered clearly and closely related if the inflation feature is nonleveraged. However, if there is leverage, an inflation feature is not clearly and closely related to a debt host. [815-15-25-50]</p>
Time value make-whole feature	<p>It depends. Hybrid instruments with embedded time value make-whole features need to be evaluated under Subtopic 815-15 to determine whether the embedded feature is considered clearly and closely related to the host contract.</p>
Overallotment options or greenshoe provisions	<p>It depends. See section 5.3.70 for further discussion on accounting for overallotment options or greenshoe provisions.</p>
Increasing-rate debt	<p>It depends. Increasing-rate debt contracts need to be evaluated under Subtopic 815-15 to determine whether the embedded feature is considered clearly and closely related to the host contract.</p>



Question 9.3.260

Is an embedded conversion option clearly and closely related to convertible preferred shares?

Interpretive response: It depends. A convertible preferred share is an equity instrument that allows the holder to convert the preferred share into a fixed number of the issuer's common shares. How the 'clearly and closely related' criterion is evaluated depends on whether the host contract (i.e. the preferred share) is more like debt or equity, see section 9.3.30 for information on how to make that determination.

Host contract more like debt

If the host contract is more like debt, the conversion option is not clearly and closely related to the debt host contract from the issuer's perspective. Because the conversion option is not clearly and closely related, the issuer further evaluates the other steps in the bifurcation analysis model discussed in section 9.3 to determine if the conversion option needs to be bifurcated and accounted for separately.

Host contract more like equity

If the host contract in a preferred share is more like equity, the conversion option is clearly and closely related to the equity host contract from the issuer's perspective. This is because the changes in value of the conversion option and the equity host contract are driven by the price associated with the equity host contract.

There is an issue as to whether the 'clearly and closely related' analysis requires an entity to determine if the embedded conversion option would meet the conditions for equity classification in Subtopic 815-40.

In general, we believe an embedded option that permits conversion into the entity's equity shares could be considered clearly and closely related to an equity host contract without evaluating whether that conversion option meets the conditions for equity classification if it were a freestanding instrument. However, this is only if the changes in value of the conversion option and the equity host contract are driven by the price associated with the equity host contract. For example, if the terms of the embedded conversion option in an equity host contract are adjusted based on changes in the price of gold or the price of a third party's equity shares, the option is not clearly and closely related to the equity host contract.

All relevant facts and circumstances should be considered with respect to the terms of the embedded option when making that determination.

9.3.70 Multiple embedded features



Question 9.3.270

How does an entity recognize multiple embedded derivatives in the same contract that require bifurcation?

Interpretive response: When there are multiple embedded derivatives that meet the criteria for bifurcation, Subtopic 815-15 requires all of them to be bifurcated and recorded as one compound embedded derivative. Subtopic 815-15 also clarifies that only those embedded derivatives that are required to be bifurcated are bundled into this compound derivative. [815-15-25-7 – 25-10]

9.3.80 Unable to reliably identify and measure embedded derivatives



Question 9.3.280

How does an entity recognize an instrument when its embedded derivative cannot be reliably identified and measured?

Interpretive response: The entire hybrid instrument is measured at fair value, with gains and losses reported in earnings. This is referred to as the practicality exception. [815-15-25-52 – 25-53]

In practice, we believe that such occurrences are rare; therefore, an entity should rarely, if ever, conclude that it cannot reliably identify and measure the embedded derivative.

9.4 Initial measurement

9.4.10 Hybrid instruments with embedded features that are not separated

When an entity elects the fair value option for a hybrid instrument, it does not bifurcate the instrument's embedded derivative. Instead, it initially records the entire hybrid instrument at fair value. The same treatment applies to a hybrid instrument that is subject to the practicality exception – i.e. an instrument for which the embedded derivative cannot be reliably identified and measured. As noted in Question 9.3.280, we expect the practicality exception to apply rarely. [815-15-30-1]

Hybrid instruments with embedded features that are not required to be bifurcated under Subtopic 815-15, and for which an entity has not elected the fair value option, are accounted for under US GAAP applicable to the hybrid instrument.



Question 9.4.10

Can an embedded feature be allocated a fair value that exceeds proceeds received for the hybrid instrument?

Interpretive response: Not unless there are other rights or privileges that require separate accounting recognition as an asset. Instead, the maximum amount that can be assigned to an embedded derivative is generally the proceeds received, with the excess of fair value over proceeds received recorded as a loss in earnings. [\[2014 AICPA Conf\]](#)

For example, the conversion feature in a convertible debt instrument may have a fair value in excess of the proceeds allocated to the convertible debt instrument – e.g. when the conversion feature is significantly in-the-money at issuance. If the conversion feature requires bifurcation, the proceeds allocated to it cannot exceed the proceeds received. This would result in the debt component of the convertible instrument (host contract) having an initial carrying amount of zero. For guidance on the subsequent recognition of interest cost on the debt component of a convertible debt instrument with an initial carrying amount of zero, see Question 10.3.50.

9.4.20 Hybrid instruments with embedded features that are separated



Question 9.4.20

How is a bifurcated embedded derivative and its host contract measured?

Interpretive response: When an entity is required to bifurcate an embedded derivative and account for it separately, the embedded derivative is initially measured at fair value. The difference between the fair value of the embedded derivative and the proceeds received from the issuance of the debt or equity instrument is then allocated to the host contract and that becomes the basis of the host contract. [\[815-15-30-2\]](#)



Question 9.4.30

How is a host contract accounted for after an embedded derivative has been bifurcated?

Interpretive response: After the embedded derivative has been bifurcated from the host contract, the host contract is then accounted for under other relevant US GAAP, such as Topic 470 (debt instruments) or Topic 505 (equity instruments). [815-15-25-54]



Question 9.4.40

What is the initial fair value of a non-option embedded derivative?

Interpretive response: At inception, the terms of a non-option embedded derivative (such as a forward or a swap) are determined in a manner that results in its fair value equaling zero. Based on the issuance date of the hybrid instrument, the entity recording the embedded derivative selects a set of terms that results in the fair value of the embedded derivative being zero.

The non-option embedded derivative should contain a notional amount and an underlying consistent with the terms of the hybrid instrument. Artificial terms should not be created to introduce leverage, asymmetry or some other risk exposure not already present in the hybrid instrument.

Generally, the appropriate terms for the non-option embedded derivative will be readily apparent and they may be different than the legal terms of the instrument. Often, simply adjusting the reference forward price to be at-the-market for the purposes of separately accounting for the embedded derivative will result in that non-option embedded derivative having a fair value of zero.

This may result in an entity needing to maintain two sets of documentation: [815-15-30-4 – 30-5]

- one for the legal terms of the hybrid instrument; and
 - one for the terms of the host contract and embedded derivative that were modified to obtain a fair value of zero for the embedded derivative. The entity uses the modified terms for all subsequent accounting for the host contract and the bifurcated embedded derivative.
-



Question 9.4.50

Are the terms for an option-based embedded derivative adjusted when determining the initial fair value?

Interpretive response: No. When the embedded derivative to be bifurcated is option based, the strike price of the embedded derivative is based on the stated terms of the hybrid instrument and should not be adjusted. Because the strike

price stated in the agreement may not equal the market price of the underlying, this will typically result in a fair value of the bifurcated option-based derivative that is other than zero. [815-15-30-6]

9.5 Subsequent measurement

9.5.10 Hybrid instruments with embedded derivatives that are not separated



Question 9.5.10

How is a hybrid instrument measured in subsequent periods when its embedded derivative is not separated?

Interpretive response: An embedded derivative in a hybrid instrument is not separated when an entity either: [815-15-25-1, 815-15-25-52]

- has elected to measure the hybrid instrument at fair value; or
- is unable to reliably identify and measure the embedded derivative and applies the practicality exception (see Question 9.3.280).

In either case, the hybrid instrument is measured at fair value each reporting period. The change in fair value each period is reported in earnings. [815-15-35-1 – 35-2]

A different subsequent measurement principle applies if an embedded derivative is not separated because it does not meet the bifurcation criteria in Subtopic 815-15 (see section 9.3). In this case, if the entity has not elected the fair value option, it measures the hybrid instrument under the US GAAP applicable to the hybrid instrument.



Question 9.5.20

When the fair value option is elected, are all changes in fair value reported in earnings?

Interpretive response: No. The portion of the total change in the fair value of the hybrid instrument that results from a change in the instrument-specific credit risk is presented in OCI. The rest of the change in fair value is reported in earnings. [815-15-45-2, 825-10-45-5]

9.5.20 Hybrid instruments with embedded derivatives that are separated



Question 9.5.30

How is a bifurcated embedded derivative measured in subsequent periods?

Interpretive response: When an embedded derivative is bifurcated and accounted for separately, it is recorded at fair value each period, with changes in fair value reported in earnings – unless the derivative is designated in a qualifying cash flow hedging relationship.

There is a caveat when the host contract is also reported at fair value – e.g. an investment in a debt security that is classified as available for sale. In this case, the sum of the fair values of the host contract and the derivative instrument cannot exceed the overall fair value of the hybrid instrument. If the sum of the fair values exceeds the fair value of the overall instrument, it indicates that the method or model used to measure the fair value of each instrument may not be appropriate and should be reevaluated. [815-15-35-2A – 35-3]



Example 9.5.10

Subsequent accounting for a hybrid debt instrument and its bifurcated embedded derivative

On January 1, Year 5, Issuer issues a series of \$1,000, five-year bonds at par value with a coupon interest rate of 5%, payable annually. The bonds contain an equity-indexed feature that is payable in cash if it is in-the-money at maturity of the debt and requires bifurcation. At issuance, the option is worth \$100.

Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	1,000	
Bonds payable – Discount ¹	100	
Bonds payable		1,000
Derivative liability		100
<i>To recognize issuance of bond and bifurcated derivative.</i>		
Note:		
1. The discount is presented gross in this example.		

At December 31, Year 5 the option feature has appreciated such that its fair value is \$250. Issuer records the amortization of the debt discount (using the effective interest method), the mark-to-market on the derivative for the year, and accrued interest on the debt as follows.

	<i>Debit</i>	<i>Credit</i>
Loss on embedded derivative ¹	150	
Interest expense ²	67	
Derivative liability ¹		150
Bonds payable – Discount		17
Accrued interest payable ³		50
<i>To recognize change in fair value of derivative and interest expense on bond.</i>		
Notes:		
1. Change in fair value of the embedded derivative from issuance to December 31, Year 5 (\$250 - \$100).		
2. Sum of interest expense from the stated rate on the bond and the amortization of the debt discount (\$50 + \$17).		
3. 5% on the \$1,000 par value of the bond.		

9.5.30 Reassessment of embedded derivatives



Question 9.5.40

When does an entity need to reevaluate an embedded derivative for bifurcation?

Interpretive response: We believe an entity needs to continuously reevaluate certain of the criteria that determine whether an embedded derivative should be bifurcated. However, we understand that many entities operationalize this requirement by reevaluating embedded derivatives at each reporting date.

Even if an embedded derivative was initially bifurcated and recorded separately, an entity needs to reevaluate to determine if that derivative should continue to be bifurcated. In performing the reevaluation, an entity generally does not need to reconsider the determination that the embedded derivative is not clearly and closely related to the host contract, unless the hybrid instrument's contractual terms have been changed (see Question 9.5.50).

Further, as a practical matter, whether the scope exception for certain foreign currency transactions in Subtopic 815-15 applies typically will not change for a debt instrument (see Question 9.2.30).

However, an entity does need to assess the remaining criteria – i.e. whether the embedded derivative meets the definition of a derivative or qualifies for one of the scope exceptions in Subtopic 815-10.

Reevaluating whether the embedded derivative meets the definition of a derivative

As a practical matter, in subsequent periods the characteristics of having an underlying and notional/payment provision or having an initial net investment will not change with time. However, the application of the net settlement criteria may change over time. Changes to the contractual net settlement provisions may be unlikely or infrequent, but – even so – the market mechanism and readily-convertible-to-cash provisions will require reconsideration because they consider external factors that may change over time (see Questions 9.3.100 to 9.3.130).

Reevaluating applicability of a Subtopic 815-10 scope exception

We believe an entity needs to reevaluate whether an embedded derivative continues to qualify for one of the scope exceptions from derivative accounting (see Question 9.3.140) or if it later qualifies for a scope exception that it did not initially qualify for. The reevaluation is performed based on facts and circumstances as of the date of the reevaluation.



Question 9.5.50

Does the determination that an embedded derivative is clearly and closely related to the host contract ever need to be reassessed?

Interpretive response: If the contractual terms of a hybrid instrument are modified and an entity determines that the modification is an extinguishment of the original instrument and issuance of a new instrument, we believe an entity needs to evaluate all embedded features as it would with the issuance of any new instrument.

In contrast, if the contractual terms of the hybrid instrument are modified and the modified instrument is not accounted for as a new instrument, judgment is required to determine if reevaluation of whether the embedded features are clearly and closely related to the host contract is necessary. We believe examples of instances when such a reevaluation is necessary, include but are not limited to:

- a modification to an existing debt instrument to include a new embedded feature (e.g. term extension option);
- a modification that changes the nature of the host contract (e.g. an entity initially determines a host contract is more akin to an equity instrument but changes the terms of the hybrid instrument such that the modified host contract is more akin to debt).

If the instrument has not been modified, the entity generally will not need to reassess its prior 'clearly and closely related' determination (see Question 9.5.40).



Question 9.5.60

Is there any limit to how many times an embedded derivative should be reassessed?

Interpretive response: No. Subtopic 815-15 requires the reassessment to be performed each reporting date. This applies even if an embedded derivative is subsequently reassessed and bifurcated in subsequent periods. Even after bifurcation, the embedded derivative should continue to be reassessed to determine if bifurcation continues to be required.

9.5.40 Recognition and measurement of a reassessed embedded derivative

Subtopic 815-15 provides limited guidance on how to account for a derivative that is either reassessed and qualifies for bifurcation or reassessed and no longer meets the criteria for bifurcation. The guidance in this section reflects reasonable approaches to accounting for reassessed embedded derivatives.

Embedded derivatives that subsequently qualify for bifurcation



Question 9.5.70

How is an embedded derivative measured and recorded when it is not initially bifurcated but is bifurcated in a subsequent period?

Interpretive response: Embedded derivatives that initially qualify for bifurcation are recorded at fair value. Based on this guidance, we believe an embedded derivative that did not initially require bifurcation but when reassessed subsequently requires bifurcation should be:

- measured at its fair value on the date it meets the criteria for bifurcation, see section 9.3.20 on how to determine the fair value; and
- bifurcated from the then-carrying amount of the host contract.

Bifurcating the embedded derivative at fair value from the carrying amount of a debt host contract results in an adjustment to a discount or premium on the debt. In these circumstances, a new effective interest rate is calculated and the premium or discount is amortized over the remaining term of the debt host contract based on that rate.

See Question 9.5.80 for further discussion when the embedded derivative that requires bifurcation was previously accounted for as a separate component of equity.



Question 9.5.80

How is a bifurcated embedded derivative recorded when it was previously accounted for as a separate component of equity?

Interpretive response: In some circumstances, an entity determines that an embedded derivative that was previously accounted for as a separate component of equity (e.g. a conversion option) subsequently meets the criteria to be recorded as a derivative.

We believe an amount equal to the fair value of the embedded derivative on the date it meets the criteria for bifurcation should be reclassified from stockholders' equity to a liability account. Any difference between the amount previously recognized in equity and the fair value of the embedded derivative at that date is accounted for as an adjustment to stockholders' equity. [\[815-40-35-9\]](#)

Bifurcated derivatives that subsequently do not qualify for bifurcation



Question 9.5.90

How is an embedded derivative (other than a conversion option or other equity-linked feature) measured and recorded when it no longer qualifies for bifurcation in subsequent periods?

Interpretive response: Subtopic 815-15 provides limited guidance on how to account for an embedded derivative (other than a conversion option or other equity-linked feature) that is reevaluated and no longer meets the criteria for bifurcation. We believe that such a bifurcated embedded derivative that, when reevaluated, no longer qualifies for bifurcation, should be remeasured to fair value on the date it ceases to qualify for bifurcation with changes in fair value recognized in earnings, then reclassified to the carrying amount of the host instrument. Any gains or losses recorded while the embedded derivative was bifurcated and accounted for as a derivative are not reversed.

If the host contract is a debt instrument, reclassifying the bifurcated embedded derivative to the carrying amount of the host contract results in an adjustment to a discount or premium on the debt that is amortized using the effective interest method over the remaining life of the debt instrument.

Bifurcated conversion options or other equity-linked features are discussed in Question 9.5.100.



Question 9.5.100

How is an embedded conversion option (or other equity linked feature) measured and recorded when it no longer qualifies for bifurcation in subsequent periods?

Interpretive response: An embedded conversion option in a convertible instrument may initially be bifurcated and accounted for separately under Subtopic 815-15. At a subsequent date, the entity may conclude that the conversion option does not meet the requirements to be bifurcated. In this case, the conversion option is remeasured to fair value on the date it ceases to qualify for bifurcation with changes in fair value recognized in earnings, then reclassified to shareholders' equity. We believe this treatment is appropriate for any equity-linked embedded derivative. Any gains or losses recorded while the embedded derivative was bifurcated and accounted for as a derivative are not reversed. [815-15-35-4]

Any discount recorded when the conversion option was bifurcated continues to be amortized. [815-15-35-4]

For guidance about accounting for a subsequent exercise of the conversion option, see Question 10.7.50. For guidance about extinguishment of the convertible debt, see Question 4.10.60.

9.6 Presentation and disclosure

The presentation and disclosure requirements for hybrid instruments depends on whether they contain bifurcated embedded derivatives.



Question 9.6.10

What are the presentation and disclosure requirements for a hybrid instrument with a bifurcated embedded derivative?

Interpretive response:

Bifurcated embedded derivative

The bifurcated embedded derivative has the same presentation and disclosure requirements as a freestanding derivative accounted for under Subtopic 815-10. For further discussion on disclosure requirements, see KPMG Handbook, [Derivatives and hedging](#).

Host contract

The host contract has the same presentation and disclosure requirements as either a debt instrument (Topic 470) or an equity instrument (Topic 505). See sections 3.8 and 5.12 for presentation and disclosure requirements under Topic 470 and Topic 505 respectively.



Question 9.6.20

What are the presentation and disclosure requirements for a hybrid instrument measured at fair value?

Interpretive response: When an entity elects to measure a hybrid instrument at fair value, its embedded derivative is not bifurcated and accounted for separately. The following are the presentation and disclosure requirements for such a hybrid instrument.

Presentation

If the hybrid instrument is measured at fair value with changes in fair value reported in earnings, it is presented either: [\[815-15-45-1\]](#)

- separately from assets and liabilities not measured at fair value; or
- on the same line as assets and liabilities not measured at fair value with parenthetical disclosure of the fair value amount.

Disclosure

A hybrid instrument measured at fair value is subject to the disclosure requirements in Subtopic 825-10. [\[815-15-50-1\]](#)

The entity should also disclose information that allows financial statement users to understand the effect of changes in the instrument's fair value on earnings. [\[815-15-50-2\]](#)

See KPMG Handbook, [Fair value measurement](#), for further guidance on disclosure requirements for assets and liabilities measured at fair value.



Question 9.6.30

What are the disclosure requirements when a bifurcated conversion option no longer meets the requirements to be bifurcated?

Interpretive response: If an entity subsequently determines that a bifurcated conversion option no longer meets the requirements to be bifurcated, it is required to disclose: [\[815-15-50-3\]](#)

- the changes in facts and circumstances that resulted in the conversion option no longer being bifurcated; and
 - the amount of the liability that was reclassified to stockholders' equity.
-

10. Convertible instruments

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10.1 How the standard works

A convertible instrument is a debt or equity instrument with an embedded feature that requires or allows a holder to convert the instrument to equity shares of the instrument’s issuer. An example is a bond that the holder can elect to convert to a fixed number of the issuer’s common shares at any time through the bond’s maturity.

Some instruments with embedded features referred to as ‘conversion options’ do not represent convertible instruments. Two examples are instruments with embedded conversion options that can be separately exercised, and instruments that can be converted to a variable number of shares with an aggregate fair value based predominantly on a fixed monetary amount.

The accounting for a convertible instrument can be complex because there are three different accounting models that may apply, which depend on the terms of the conversion option.

Accounting model*	Summary description
Models with separate accounting for the conversion feature	
Embedded derivative model	<ul style="list-style-type: none"> — Proceeds are allocated to the embedded conversion feature for its fair value, with remaining proceeds allocated to the host contract. — Subsequently, the embedded conversion feature is measured at fair value with changes reported in earnings.
Substantial premium model ¹	Proceeds are allocated to equity for the premium.
Model without separate accounting for the conversion feature	
No proceeds allocated model	All proceeds are allocated to the entire instrument, which is classified as a liability – i.e. there is no separate accounting for the conversion feature initially or subsequently.
Note: 1. The substantial premium model does not apply to equity-classified convertible preferred shares.	

* ASU 2020-06 eliminated the cash conversion and beneficial conversion feature models, thereby limiting the applicable models to those listed in this table. This chapter provides guidance on when and how to apply each accounting model. It includes accounting guidance for the discounts frequently recognized on convertible instruments in practice.

This chapter also includes guidance on accounting for conversions and induced conversions. This accounting depends on whether the conversion feature is bifurcated as an embedded derivative at any time before conversion – including when a conversion feature is bifurcated and subsequently reclassified to equity or vice versa.

The guidance in this chapter does not apply when the entity elects to account for eligible convertible instruments at fair value pursuant to the fair value option under Topic 825. Question 9.3.30 discusses hybrid instruments that are not eligible for this option.

While not discussed in this chapter, the following additional guidance may be useful for convertible instruments:

- Section 3.3.20 discusses how proceeds are allocated to other freestanding financial instruments (e.g. detachable warrants) issued with a convertible instrument.
- KPMG Handbook, [Accounting for income taxes](#), provides guidance on recording the tax effect of convertible instruments, including paragraphs 2.106 – 2.110, 9.057 and 9.069. For example, the allocation to equity of a portion of the proceeds from issuance of convertible instruments generally creates a temporary difference between the debt's financial statement carrying amount and its tax basis, and the related deferred tax liability is recognized through a charge to equity.
- KPMG Handbook, [Earnings per share](#), provides guidance on the EPS implications of convertible instruments, including section 6.12.

ASU 2020-06 changed 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 eliminated the cash conversion and beneficial conversion feature models, which will likely result in more convertible debt instruments being accounted for as a single unit.

10.2 Overview of the accounting

10.2.10 Scope



Excerpt from ASC 470-20

> Convertible Securities—General

05-4 A convertible debt instrument is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore, the two choices are mutually exclusive; they cannot both be consummated. Thus, the instrument will either be converted or be redeemed. The holder cannot exercise the option to convert unless he forgoes the right to redemption, and vice versa.

05-5 A convertible debt instrument may offer advantages to both the issuer and the purchaser. From the point of view of the issuer, convertible debt has a lower interest rate than does nonconvertible debt. Furthermore, the issuer of convertible debt instruments, in planning its long-range financing, may view convertible debt as essentially a means of raising equity capital. Thus, if the **fair value** of the underlying common stock increases sufficiently in the future, the issuer can force conversion of the convertible debt into common stock by calling the issue for redemption. Under these market conditions, the issuer can effectively terminate the conversion option and eliminate the debt. If the fair value of the stock does not increase sufficiently to result in conversion of the debt, the issuer will have received the benefit of the cash proceeds to the scheduled maturity dates at a relatively low cash interest cost.

05-6 On the other hand, the purchaser obtains an option to receive either the face or redemption amount of the instrument or the number of common shares into which the instrument is convertible. If the fair value of the underlying common stock increases above the conversion price, the purchaser (either through conversion or through holding the convertible debt containing the conversion option) benefits through appreciation. The purchaser may at that time require the issuance of the common stock at a price lower than the fair value. However, should the fair value of the underlying common stock not increase in the future, the purchaser has the protection of a debt security. Thus, in the absence of default by the issuer, the purchaser would receive the principal and interest if the conversion option is not exercised.

05-7 Entities may issue convertible debt instruments that may be convertible into common stock at the lower of a conversion rate fixed at **time of issuance** and a fixed discount to the market price of the common stock at the date of conversion.

05-7A Entities also may issue convertible debt instruments that, by their stated terms, may be settled in cash (or other assets) upon conversion, including partial cash settlement.

05-8 Certain convertible debt instruments may have a contingently adjustable conversion ratio; that is, a conversion price that is variable based on future events such as any of the following:

- a. A liquidation or a change in control of an entity
- b. A subsequent round of financing at a price lower than the convertible security's original conversion price
- c. An initial public offering at a share price lower than an agreed-upon amount.

05-8A Certain convertible debt instruments may become convertible only upon the occurrence of a future event that is outside the control of the issuer or holder.

> Entities

15-1 The guidance in this Subtopic applies to all entities.

> Instruments

15-2 The guidance in this Subtopic applies to all debt instruments. The guidance on own-share lending arrangements applies to an equity-classified share-lending arrangement on an entity's own shares when executed in contemplation of a convertible debt offering or other financing.

15-2A The guidance on convertible debt instruments in this Subtopic shall be considered after considering the guidance in the Fair Value Option Subsections of Subtopic 825-10 on financial instruments.

15-2B The guidance on convertible debt instruments in this Subtopic shall be considered after considering the guidance in Subtopic 815-15 on bifurcation of embedded derivatives for an embedded conversion option or other embedded feature (for example, an embedded prepayment option) as applicable (see paragraph 815-15-55-76A). The relevant guidance in this Subtopic does not affect an issuer's determination under Subtopic 815-15 of whether an embedded conversion option or other embedded feature shall be separately accounted for as a derivative instrument.

15-2C The guidance in this Subtopic does not apply to a convertible debt instrument award issued to a grantee that is subject to the guidance in Topic 718 on stock compensation unless the instrument is modified as described in and no longer subject to the guidance in that Topic. The guidance in this Subtopic does not apply to stock-settled debt that is subject to the guidance in Subtopic 480-10 on distinguishing liabilities from equity or other Subtopics (see paragraph 470-20-25-14), unless the stock-settled debt also contains a substantive conversion feature (as discussed in paragraphs 470-20-40-7 through 40-10) for which all relevant guidance in this Subtopic shall be considered in addition to the relevant guidance in other Subtopics.

15-2D For purposes of determining whether an instrument is within the scope of this Subtopic, a convertible preferred stock shall be considered a convertible debt instrument if it has both of the following characteristics:

- a. It is a mandatorily redeemable financial instrument.
- b. It is classified as a liability under Subtopic 480-10.

> Overall

25-1 The guidance in this Section shall be considered after consideration of the guidance in the Fair Value Option Subsections of Subtopic 825-10 on financial instruments and the guidance in Subtopic 815-15 on bifurcation of embedded derivatives, as applicable....

• > Scope Application to a Convertible Preferred Stock

55-1A An example of a convertible preferred stock that paragraph 470-20-15-2D requires an entity consider as a convertible debt instrument for purposes of the scope application of this Subtopic is a convertible preferred stock that has a stated redemption date and also would require the issuer to settle the face amount of the instrument in cash upon exercise of the conversion option. Such a convertible preferred stock is a mandatorily redeemable financial instrument and is classified as a liability under Subtopic 480-10 because it embodies an unconditional obligation to redeem the instrument by transferring assets at a specified or determinable date (or dates).


A convertible instrument is an instrument that contains an embedded option to convert the instrument into the issuer’s equity shares, such as the option to convert a debt instrument into a fixed number of the issuer’s common shares. Conversion options frequently have additional features.

Examples of features of conversion options [470-20-15-04 – 15-8A]	
Conversion rate that is adjustable based on the lower of: <ul style="list-style-type: none"> — a rate fixed at issuance of the convertible instrument; and — a fixed discount to the issuer’s common share market price when the instrument is converted. 	A contingency that affects the number of shares issuable on conversion based on a future event, such as the following: <ul style="list-style-type: none"> — a liquidation or a change in control of the issuer; — a subsequent round of financing by the issuer at a price lower than the convertible instrument’s original conversion price; or — an IPO by the issuer at a share price lower than an agreed-upon amount.
Cash conversion feature that permits the issuer to settle a conversion in cash (or other assets), including partial cash settlement.	Exercise contingency whereby the conversion option is exercisable only if a contingent future event that is outside the control of the issuer or holder occurs.

Subtopic 470-20 provides guidance on accounting for debt instruments, including liability-classified convertible preferred shares, that have embedded conversion and other options. Certain provisions also apply to equity-classified convertible preferred shares (see Question 10.2.10). [470-20-15-2D, 55-1A]

Certain instruments have features that appear to be consistent with that of a convertible instrument, but they are not in the scope of Subtopic 470-20 (see Questions 10.2.20 and 10.2.30). Further, Subtopic 470-20 does not apply to certain convertible instruments. [470-20-15-2A – 15-2C, 25-1]

Convertible instruments not subject to Subtopic 470-20	
Instruments for which the fair value option has been elected. The fair value option is not available for convertible debt with a conversion option that is recorded separately in equity. See Question 9.3.30 about hybrid instruments that are not eligible for this option, and Question 2.3.10 about an entity's considerations when deciding whether to elect the fair value option.	Instruments with a conversion option treated as a bifurcated derivative under Topic 815.
Instruments in the scope of Topic 718 (stock compensation).	Instruments representing stock-settled debt that do not also contain a substantive conversion feature (see Question 10.2.30).

 **Question 10.2.10**
Does Subtopic 470-20 apply to convertible preferred shares?

Interpretive response: Yes, although some of the guidance in Subtopic 470-20 does not apply to convertible preferred shares that are classified in equity.

Although Subtopic 470-20 by its terms applies to convertible debt instruments, many of its concepts also apply to convertible preferred shares. Under Subtopic 470-20, convertible preferred shares are subject to the same accounting model as convertible debt, except that the guidance for a substantial premium (see section 10.4) does not apply to equity-classified convertible preferred shares.

The accounting for an equity-classified preferred share depends on whether the conversion feature is separately recorded as a derivative.

- **Conversion feature not a derivative.** The convertible preferred share is accounted for under Topic 505 in the same manner as nonconvertible preferred shares (see chapter 5).
- **Conversion feature is a derivative.** The subsequent accounting for the convertible preferred share and convertible debt is essentially the same. The following are the only differences.
 - Amortization of the discount or premium on a debt's carrying amount is recognized as interest expense while amortization of the preferred share's carrying amount, if any, is recognized as deemed dividends (or contributions) to preferred shareholders. Amortization is only recognized for preferred shares classified in temporary equity that are required to be subsequently remeasured (see chapter 7).
 - The remaining unamortized discount or premium on a debt instrument is recognized as interest expense if the instrument is converted (see Question 3.4.90), while for preferred shares, it is generally recognized as deemed dividends (or contributions) to preferred shareholders (see Question 5.4.35).

This chapter does not address EPS implications of convertible instruments; see KPMG Handbook, [Earnings per share](#), for guidance, including sections 3.3.50 and 6.12.



Question 10.2.20

Is an instrument considered convertible debt when the conversion option can be exercised separately from the instrument?

Interpretive response: No. Some entities issue instruments that are described as convertible debt but permit the holder to separately net-settle the call option on the issuer's equity shares so that the debt obligation continues to be outstanding.

We believe call options to purchase the entity's equity shares that can be exercised separately without settling the related debt obligation should be accounted for in the same manner as freestanding warrants; this is regardless of whether the option feature is characterized as a conversion option in the related transaction documents.

For guidance on allocating proceeds between debt and other freestanding financial instruments (e.g. warrants), see section 3.3.20.



Question 10.2.30

Is stock-settled debt considered convertible debt?



Excerpt from ASC 470-20

- > Convertible Debt Instruments

25-14 If a debt instrument has a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date, the instrument shall be considered stock-settled debt that is subject to the guidance in Subtopic 480-10 or other Subtopics (such as Subtopic 718-10, 815-15, or 825-10). Example 4 (see paragraph 470-20-55-18) illustrates application of the guidance in this paragraph.

- > Example 4: Stock-Settled Debt

55-18 This Example illustrates the guidance in paragraph 470-20-25-14.

55-19 If the conversion price was described as \$1 million divided by the market price of the common stock on the date of the conversion, that is, resetting at the date of conversion, the holder is guaranteed to receive \$1 million in value upon conversion and, therefore, the debt instrument would be considered stock-settled debt.

Interpretive response: No. When a conversion option continuously resets as the underlying share price changes, the instrument is stock-settled debt if the reset mechanism guarantees the holder a fixed value of common shares on conversion. Stock-settled debt is subject to the guidance in Subtopic 480-10 or other subtopics, instead of the guidance in Subtopic 470-20. [470-20-25-14]

See chapter 6 for guidance on accounting for stock-settled debt.



Question 10.2.40

To be stock-settled debt, does a conversion option's reset mechanism need to guarantee a monetary value fixed at the instrument's inception?

Interpretive response: No. The value of common shares holders will receive on conversion when a conversion option resets as the common share price changes (i.e. the monetary value of the option at conversion) does not have to be exactly the same as the monetary value fixed at the instrument's inception to cause the convertible instrument to be considered stock-settled debt. Instead, it needs to be predominantly based on the monetary value fixed at inception.

For example, the monetary value at conversion is predominantly based on the amount fixed at inception even if it is based on the change in the common shares' fair value over the last 30 days before conversion (i.e. settlement) (see Question 6.6.40). [480-10-55-22]



Example 10.2.10

Continuously resetting conversion price

On January 1, Year 4, ABC Corp. issues a note with a \$1 million principal amount. The note is convertible to ABC common shares based on 80% of the average share price for 30 days preceding the date of conversion. The note can be converted to shares at any time after three years.

The fair value of ABC's common shares on January 1, Year 4 (the commitment date) is \$50 per share. The average price per share of ABC common shares was \$45 in the 30 days preceding issuance of the note.

The conversion feature continually resets in a manner that may require ABC to deliver a variable number of shares with a monetary value that is predominantly based on \$1.25 million ($\$1 \text{ million} \div 80\%$), a fixed monetary amount.

Because the variable number of shares to be issued is based on ABC's average share price over the 30 days before settlement, the monetary value of the obligation is based, in small part, on variations in the fair value of ABC's equity shares. Assuming the notes are immediately converted, the monetary value at settlement is \$1,388,889: $(\$1 \text{ million} \div (\$45 \times 80\%)) \times \50 . This compares to a monetary value of \$1.25 million based on the \$50 share price at the settlement date.

The monetary amount of the conversion option at settlement is not fixed. However, because it is based on the change in the fair value of ABC's common shares over the last 30 days prior to settlement, the monetary value of the obligation is considered predominantly based on a fixed monetary amount known at inception.

Therefore, the note represents a stock-settled debt obligation that is in the scope of Subtopic 480-10. It should not be viewed as a convertible note in the scope of Subtopic 470-20.



Question 10.2.50

Does debt that is contingently convertible to unspecified equity shares that have not yet been issued contain a conversion option?

Interpretive response: No. In this case, generally the conversion price will result in the holder receiving a variable number of shares with an aggregate fair value based predominantly on a fixed monetary amount. Therefore, the conversion feature is like a contingent prepayment option, even though it may be referred to as a conversion option.

Some entities issue debt instruments (e.g. short-term bridge financing) with a contingent exchange feature that permits the holder to exchange the debt for any series of equity shares (including convertible preferred shares) that are issued in a subsequent round of financing in excess of a specified dollar amount. The price used to determine the number of shares issued in exchange for the debt instruments is based on the purchase price paid by the holders for the newly issued equity shares.

Therefore, the exchange feature permits the holder to receive a variable number of shares of an unspecified future series of common or preferred shares with an aggregate fair value that is based on a fixed monetary amount; that amount is generally the principal amount of the debt instrument that is being exchanged.

Because the payoff from those contingent exchange features is based on a fixed monetary amount, we believe the features generally do not embody conversion options as contemplated by Subtopic 470-20. Instead, we believe the features are generally like contingent prepayment options (i.e. put options) that are settleable in a variable number of shares.

See chapter 9 for additional discussion on embedded features, including Question 9.3.220 regarding contingent prepayment options.



Question 10.2.60

How does an entity account for the embedded feature of debt that is exchangeable for shares of another entity (i.e. exchangeable debt)?



Excerpt from ASC 470-20

> SEC Staff Guidance

- > Comments Made by SEC Observer at Emerging Issues Task Force (EITF) Meetings
- • > SEC Observer Comment: Debt Exchangeable for the Stock of Another Entity

S99-1 The following is the text of the SEC Observer Comment: Debt Exchangeable for the Stock of Another Entity.

An issue has been discussed involving an enterprise that holds investments in common stock of other enterprises and issues debt securities that permit the holder to acquire a fixed number of shares of such common stock. These types of transactions are commonly affected through the sale of either debt with detachable warrants that can be exchanged for the stock investment or debt without detachable warrants (the debt itself must be exchanged for the stock investment - also referred to as "exchangeable" debt). Those debt issues differ from traditional warrants or convertible instruments because the traditional instruments involve exchanges for the equity securities of the issuer. There have been questions as to whether the exchangeable debt should be treated similar to traditional convertibles as specified in Subtopic 470-20 or whether the transaction requires separate accounting for the exchangeability feature. The SEC staff believes that Subtopic 470-20 does not apply to the accounting for debt that is exchangeable for the stock of another entity and therefore separation of the debt element and exchangeability feature is required.

Background: A debt instrument may contain an embedded feature that permits the holder to exchange the debt for instruments other than equity shares of a parent or a consolidated subsidiary – i.e. 'exchangeable debt'. For example, debt may be exchangeable for the shares of another entity, such as the shares of an equity method investee.

Interpretive response: An embedded feature that permits the holder to exchange the debt for instruments other than equity shares of the issuer (or shares of the entity's consolidated subsidiary) is accounted for as an embedded derivative under Subtopic 815-15 (embedded derivatives).

The SEC believes that Subtopic 470-20 does not apply to exchangeable debt. As a result, the SEC requires the debt host and embedded feature to be accounted for separately. [\[470-20-S99-1\]](#)

This accounting assumes the entity did not elect the fair value option. If it did, the hybrid instrument in its entirety would be measured at fair value each reporting period (see Questions 2.3.10 and 9.3.30).



Question 10.2.70

How is a convertible equity instrument accounted for if it becomes mandatorily redeemable because the conversion option expires?



Excerpt from ASC 505-10

35-1 If convertible preferred stock is required to be redeemed once the conversion feature expires, the financial instrument becomes a liability under the guidance in Topic 480 upon expiration of the conversion feature and paragraph 480-10-30-2 requires the issuer to reclassify an instrument that becomes mandatorily redeemable as a liability, measured initially at fair value with a corresponding reduction of equity (no gain or loss is to be recognized). That may entail an adjustment to paid-in capital if, upon reclassification, the fair value of the liability differs from the carrying amount of the previously convertible preferred stock. That financial instrument would be subsequently measured under the provisions of Topic 480.

Background: Some convertible equity instruments (permanent or temporary equity) require redemption on a mandatory date if not converted before that date. Such instruments are not classified as liabilities under Subtopic 480-10 because the issuer is not required to redeem them if the holder converts before the redemption date. See Question 6.4.260.

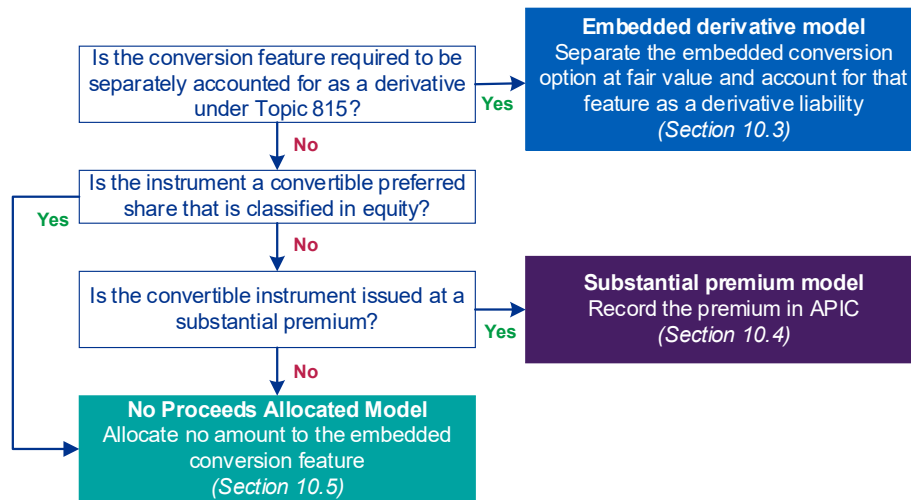
Interpretive response: If a convertible equity instrument becomes mandatorily redeemable because the conversion option expires, the entity accounts for this event as follows. [\[505-10-35-1\]](#)

1	Reclassify the instrument as a liability and record it at its reclassification-date fair value.
2	Recognize any difference between the reclassification-date fair value and the carrying amount as an adjustment to equity. See section 3.3.50 of KPMG Handbook, Earnings per share , for guidance on how this amount is treated in EPS calculations.
3	Subsequently measure the liability under Subtopic 480-10 as a mandatorily redeemable financial instrument (see section 6.9.20).

10.2.20 Accounting models for convertible instruments

Unless an entity elects the fair value option for an eligible convertible instrument (see Questions 2.3.10 and 9.3.30), an embedded conversion option is recorded under one of three accounting models. These models determine, among other things, whether the instrument’s conversion option is allocated some of the proceeds from the instrument’s issuance and how the conversion option is presented in the financial statements.

The following decision tree summarizes the steps for determining which of the three accounting models should be applied to a convertible instrument.



For each convertible instrument, an entity evaluates these models sequentially because each successive model applies only if none of the preceding models apply to the conversion feature. For example, the substantial premium model applies only if the conversion feature is not separately accounted for as a derivative liability (i.e. the embedded derivative model does not apply).

This chapter does not address accounting for the income tax effects of convertible instruments. For example, the allocation to equity of a portion of the proceeds from issuance of a convertible debt instrument generally creates a temporary difference between the debt’s financial statement carrying amount and its tax basis, with the related deferred tax liability recognized through a charge to equity. See KPMG Handbook, [Accounting for income taxes](#), for guidance on recording the tax effect of convertible instruments, including paragraphs 2.106 to 2.110, 9.057 and 9.069.

10.3 Embedded derivative model

10.3.10 Overview



Excerpt from ASC 815-15

> Certain Convertible Securities

55-76A The following steps specify how an issuer shall apply the guidance on accounting for embedded derivatives in this Subtopic to a convertible debt instrument within the scope of Subtopic 470-20.

- a. Step 1. Identify embedded features, including the embedded conversion option that must be evaluated under Subtopic 815-15.
- b. Step 2. Apply the guidance in Subtopic 815-15 to determine whether any of the embedded features identified in Step 1 must be separately accounted for as derivative instruments.
- c. Step 3. Apply the guidance in Subtopic 470-20 to account for the convertible debt instrument (including the embedded conversion option and any other embedded features, which are not separately accounted for as a derivative instrument in Step 2) as a liability.
- d. Step 4. If one or more embedded features are required to be separately accounted for as a derivative instrument based on the analysis performed in Step 2, that embedded derivative shall be separated from the host contract in accordance with the guidance in this Subtopic.

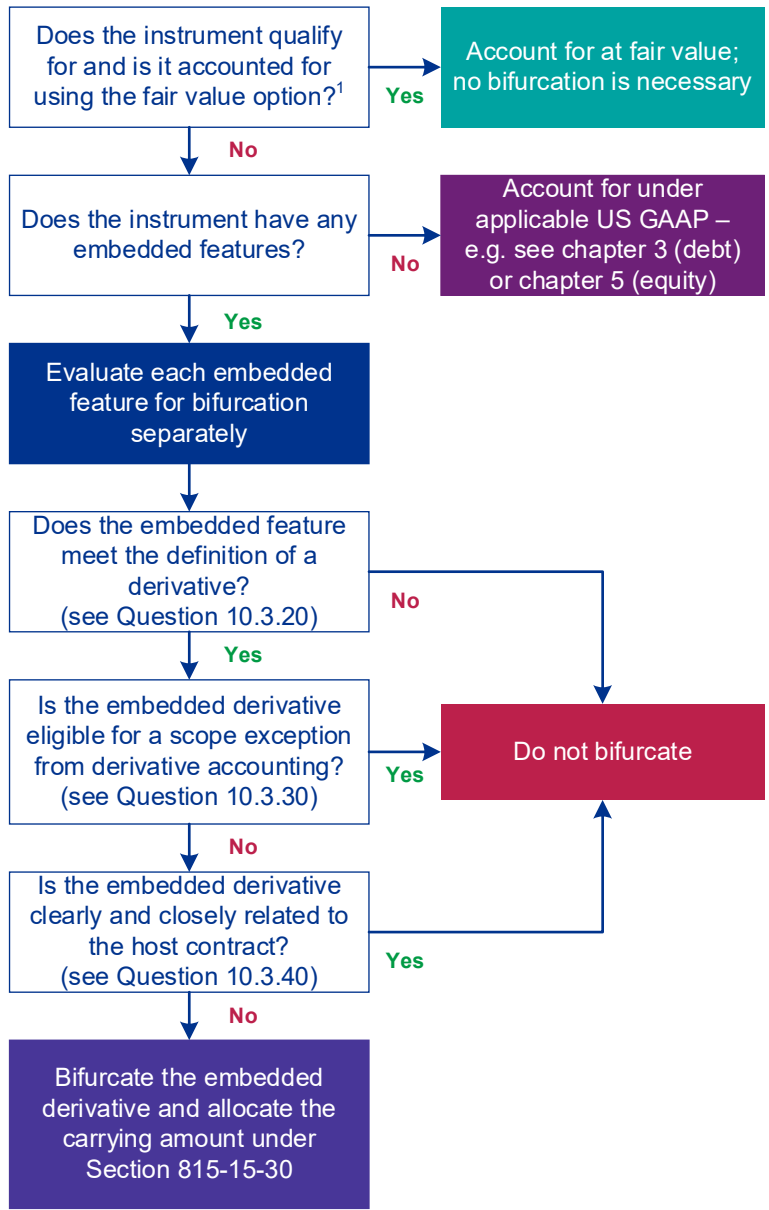
55-76B An issuer should follow steps similar to those in paragraph 815-15-55-76A to apply the accounting guidance for embedded derivatives in this Subtopic to convertible preferred stock within the scope of Subtopic 505-10, except that in Step 3 the convertible preferred stock (including the conversion option and any other embedded features, which are not separately accounted for as a derivative instrument in Step 2) should be accounted for as equity in accordance with Subtopic 505-10.

The first step in determining the appropriate accounting for a convertible instrument (i.e. all convertible debt and preferred shares) is to determine if any of its embedded features should be bifurcated and accounted for as a derivative under Topic 815. Not only is the conversion option tested for bifurcation, but also any other embedded features – e.g. prepayment options and contingent interest or dividend provisions.

Topic 815 requires assessment of embedded features for bifurcation on an ongoing basis. As a consequence, changing circumstances may require an embedded feature that was initially determined not to be accounted for as a derivative requiring bifurcation to be bifurcated at a later date. Embedded features that were not initially bifurcated need to be evaluated each period for changes in circumstances that could require them to be bifurcated. For further guidance on bifurcating embedded derivatives in subsequent periods, see section 9.5.30.

Question 10.3.10
When is a convertible instrument's embedded feature a derivative requiring bifurcation?

Interpretive response: An embedded feature is accounted for as a derivative (and therefore bifurcated from the convertible instrument) if it meets the criteria for derivative accounting. The key decisions for determining whether an embedded feature should be bifurcated are summarized in the following decision tree, which is applied separately for each feature. [815-15-25-1]



Note:

1. For example, an eligible financial instrument for which the entity has elected the fair value option. [825-10-45-5 – 45-7]

There is no requirement to evaluate these criteria in any particular sequence. In practice, the analysis is simplified if the answer to any of the questions in the above decision tree leads to the 'Do not bifurcate' outcome.

For example, for an equity-classified convertible preferred share, it may be easier to first evaluate whether the conversion option is clearly and closely related to the host contract before evaluating whether the equity scope exception from derivative accounting applies. If it is determined that the host contract is more like equity and therefore the conversion option is clearly and closely related to the equity host, there is no need to evaluate whether the equity scope exception from derivative accounting applies.

Questions 10.3.20 to 10.3.40 explain certain of these questions as they relate to conversion features embedded in a convertible instrument. However, each step requires a detailed analysis and is explained more thoroughly in chapter 9; see also chapter 3 of KPMG Handbook, [Derivatives and hedging](#).



Question 10.3.20

When does a conversion option embedded in a convertible instrument meet the definition of a derivative?

Interpretive response: A derivative is defined as having all of the following characteristics: [\[815-10-15-83\]](#)

- underlying, notional and/or payment provision;
- no or small initial net investment; and
- net settleable.

A conversion option typically meets the first two characteristics. For example, the issuer's share price is an underlying, and the number of shares into which the instrument converts is a notional amount. Further, an embedded conversion option typically meets the characteristic of requiring no (or small) initial net investment as explained in Question 9.3.90. [\[815-10-15-88, 15-92, 815-15-25-1\(c\)\]](#)

Therefore, whether a conversion option meets the definition of a derivative will typically depend on whether the net settlement characteristic is met. There are at least two ways an embedded conversion option can meet the 'net settleable' criterion. [\[815-10-15-83\(c\), 15-99\]](#)

- **The instrument is net settleable under its contractual terms.** While this generally is not the case with convertible instruments, some instruments provide for contractual net settlement. For example, when a convertible instrument permits the issuer to settle the conversion spread with shares having a value equal to the conversion spread, the instrument provides for contractual net settlement (even if the underlying shares are not readily convertible to cash).
- **The shares to be delivered on conversion are readily convertible to cash.** This is usually the case when the shares underlying a convertible instrument are publicly traded because the instrument's holder could sell the shares in the open market immediately on conversion. In contrast, when the underlying shares are not publicly traded, or the trading volumes

are less than the number of shares underlying the conversion option (considering any ability to exercise the conversion option in increments), the delivered shares typically are not readily convertible to cash and the 'net settleable' criterion is not met.

If the conversion option meets the definition of a derivative, the entity then determines if a scope exception from derivative accounting applies (see Question 10.3.30).

In contrast, if the conversion option does not meet the definition of a derivative, it is not bifurcated as a derivative and not accounted for under the embedded derivative model.



Example 10.3.10

Effect of contingent put option on whether an embedded conversion option meets net settlement characteristic

Issuer issues a private placement convertible note with a conversion option settleable in Issuer's own shares. The offering memorandum states that, on conversion of the note, Holder may request Issuer to deliver registered shares. If Issuer is unable to deliver registered shares, Holder may select between two settlement options:

- receive unregistered shares; or
- trigger a covenant breach that requires Issuer to redeem the note for the accreted principal amount plus any accrued interest (which effectively acts as a contingent put option)

The convertible note includes two separate embedded features: a conversion option and a contingent put option.

Conversion option

The existence of the contingent put option does not result in contractual net settlement of the conversion option when determining whether the conversion option meets the definition of a derivative – i.e. settlement of the contingent put option (i.e. the second settlement alternative when registered shares are not available) is not considered to be a net-cash settlement of the conversion option. As a result, if the conversion option is not net settleable for another reason (see Question 10.3.20), the conversion option would not require bifurcation because it does not meet the definition of a derivative.

In addition, assuming the conversion option meets the definition of a derivative, settlement of the contingent put option is not considered to be a net-cash settlement of the conversion option when determining whether the equity classification guidance is met and, thus, the conversion option is eligible for the own equity scope exception from derivative accounting (see section 8.10.10).

Contingent put option

In addition to evaluating the conversion option, the contingent put option also is evaluated to determine whether it is an embedded derivative that requires bifurcation. As discussed in Question 9.3.110, the potential settlement of the

debtor's obligation to the creditor upon exercise of a put option or call option meets the net settlement criterion. However, as discussed in Question 9.3.10, there are three criteria for determining whether an embedded feature must be bifurcated, and they do not need to be evaluated in any particular sequence. When evaluating a contingent put option in a debt host contract, it may be easier to first evaluate whether the economic characteristics of the contingent put option are 'clearly and closely related' to those of the host contract (see Question 9.3.220). If so, the embedded feature is not bifurcated and accounted for separately. If not, the embedded feature is evaluated to determine if the other criteria are met.



Question 10.3.30

What exception from derivative accounting is most likely to apply to a conversion feature embedded in a convertible instrument?

Interpretive response: There are various scope exceptions in Topic 815, but the most common exception that applies to conversion options is the own equity scope exception from derivative accounting, which applies to instruments or embedded features that are both: [815-10-15-74(a)]

- indexed to the issuer's own stock; and
- classified in stockholders' equity on the issuer's balance sheet.

In some situations, contingencies cause a conversion option to not be considered indexed to the issuer's own equity shares. Therefore, both exercise contingencies and contingencies that can affect the number of shares issuable on conversion need to be evaluated.

Chapter 9 provides further guidance about when these criteria are met.

If a conversion option that is otherwise required to be bifurcated (based on the questions in the decision tree in Question 10.3.10) does not meet both of these criteria, it is treated as an embedded derivative and accounted for under the embedded derivative model.

In contrast, if the conversion option meets both of these criteria, it is not bifurcated as a derivative and not accounted for under the embedded derivative model.



Question 10.3.40

How is the 'clearly and closely related' criterion applied to conversion features embedded in a convertible instrument?

Interpretive response: Whether there is a clear and close relationship depends on whether the nature of the host contract is debt or equity. This determination is required before performing the 'clearly and closely related' analysis because convertible instruments sometimes have characteristics of both debt and equity instruments (see section 9.3.40).

- **Nature of the host contract is more like debt** – e.g. most convertible debt instruments and some convertible preferred share instruments. Changes in the fair value of a conversion feature (which allows for conversion to an equity interest) generally are not clearly and closely related to a debt host contract.
- **Nature of the host contract is more like equity** – e.g. most convertible preferred share instruments. The conversion feature is clearly and closely related and therefore does not require bifurcation.

Section 9.3.60 further explains how to determine if the economic characteristics and risks of the conversion option are clearly and closely related to the economic characteristics and risks of the convertible instrument – i.e. the host contract.

If there is a clear and close relationship between the conversion feature and the host instrument, the embedded derivative model does not apply.

10.3.20 Recognition and initial measurement

When the conversion feature is accounted for as a derivative, it is measured at fair value on the issuance date. The difference between the proceeds allocated to the convertible instrument at issuance and the fair value of the conversion feature is allocated to the host contract. [815-15-30-2]

For examples of recording debt and equity instruments with a bifurcated derivative, see chapter 9.

10.3.30 Subsequent measurement

A bifurcated conversion derivative is measured at fair value in subsequent periods, with changes in fair value reported in earnings (see section 9.5.20). [815-10-35-1]

Bifurcating the conversion feature (or any other embedded derivative) results in the host instrument being recorded at a discount. The discount is accreted, along with any other discount resulting from issuance costs, over the term of the instrument using the effective interest method. For guidance on accretion in subsequent periods, see also section 3.5 related to debt instruments and section 5.4 related to equity-classified preferred shares.



Question 10.3.50

How is a discount accreted if no amount is allocated to the host contract of the convertible instrument?

Background: If an embedded derivative's fair value equals (or exceeds) the proceeds allocated to the convertible instrument, the initial carrying amount of the host contract is zero (i.e. a discount of 100%). See also Questions 3.3.40

and 9.4.10 about allocating proceeds when an embedded derivative's fair value exceeds proceeds received for the hybrid instrument.

Interpretive response: When the initial carrying amount of an instrument is zero due to the recognition of an embedded derivative, it is not mathematically possible to apply the effective interest method. In that circumstance, there are differing views related to the subsequent measurement of the debt component of the convertible instrument.

We believe the following approaches are acceptable accounting policies for accreting the discount. However, there may be other methods that are also acceptable. The chosen accounting policy should be applied consistently.

- Accrete the discount using the **straight-line method**. In our experience, this approach is used most widely.
- Assume a **nominal initial value** (e.g. \$0.01) and apply the effective interest method. Under this approach, substantially all of the interest (or dividend) cost will be recognized near the end of the discount accretion period.
- Create a **hypothetical amortization table** based on the estimated fair value of the instrument without the conversion option – i.e. assign an initial carrying amount based on the estimated fair value without the conversion option. Using that table, determine the ratio of interest (or dividend) cost that would be recognized for the current period to the total interest (or dividend) cost that would be recognized over the entire discount accretion period. Then determine the actual interest (or dividend) cost to be recognized each period by multiplying that ratio by the total discount that will be recognized over the entire discount accretion period.

An instrument's initial carrying amount of zero does not affect the determination of the appropriate accretion period for the related discount.

10.4 Substantial premium model

10.4.10 Overview



Excerpt from ASC 470-20

> Convertible Debt Instruments

25-13 If a convertible debt instrument is issued at a substantial premium, there is a presumption that such premium represents paid-in capital.

If a convertible instrument (other than an equity-classified preferred share) is not accounted for under the embedded derivative model, an entity determines whether the instrument was issued at a substantial premium. A substantial premium exists if the amount of issuance proceeds assigned to the convertible instrument substantially exceeds the instrument's principal amount. Generally, such a premium is recorded in equity unless the premium is not associated with the value of the conversion feature – e.g. the conversion feature is not

substantive; see section 10.7.40 for information about determining whether a conversion feature is substantive. [470-20-25-13]



Question 10.4.10

When is a premium considered substantial?

Interpretive response: US GAAP does not define the term ‘substantial premium.’ Historically, a premium of 10% or more above the principal amount of the debt instrument has generally been considered substantial in practice. However, we believe future judgments about what constitutes a substantial premium may be informed by the FASB’s rationale for retaining – instead of eliminating – the substantial premium model in ASU 2020-06.

The substantial premium model was not commonly applied in practice before ASU 2020-06. This is because most conversion features that resulted in an instrument being issued at a premium were separately recorded in equity under the cash conversion or beneficial conversion feature models, which ASU 2020-06 eliminated.

The FASB originally proposed to eliminate the substantial premium model as well. However, the substantial premium model was ultimately retained because of concerns that a convertible debt instrument issued at a substantial premium and accounted for as a single unit could give rise to net interest income, instead of interest expense – e.g. when premium amortization exceeds contractual (cash) interest. Under the model, the premium is recorded in APIC with no amortization. In practice, this rationale may result in an entity determining that a premium is substantial when such a premium would otherwise result in recognizing net interest income, instead of interest expense. [ASU 2020-06.BC33–BC35]



Example 10.4.10

Convertible debt issued at a substantial premium

ABC Corp. issues convertible debt with a \$1,000 par value for \$1,250. The debt is convertible to 50 ABC common shares with a par value of \$1 per share. The fair value of ABC common shares at the issuance date is \$25 per share resulting in an if-converted value at issuance of \$1,250 (50 shares × \$25 per share). The debt bears interest at 2%.

For simplicity, this example does not reflect debt issuance costs.

ABC will pay \$100 of cash interest over the debt’s term ($\$1,000 \times 2\% \times 5 \text{ years} = \100). The premium of \$250 over the debt’s par value is greater than that amount. Amortization of the premium would result in net interest income of \$150 over the debt’s term (\$250 premium – \$100 interest expense). As such, ABC concludes that the bonds were issued at a substantial premium and records the premium as a component of equity at initial recognition.

ABC records the following journal entry.


	<i>Debit</i>	<i>Credit</i>
Cash	1,250	
Bonds payable ¹		1,000
APIC ²		250
<i>To recognize issuance of bonds.</i>		
Notes:		
1. \$1,000 bonds recorded at their par value.		
2. \$1,250 total issuance price less the debt at par value (\$1,250 – \$1,000 = \$250).		

10.4.20 Recognition and initial measurement

When a convertible instrument is in the scope of the substantial premium model, the premium is recorded in equity and the obligation is recorded as debt at its par value. [470-20-25-13]

10.4.30 Subsequent measurement

A debt component of a convertible instrument is in the scope of the substantial premium model is recorded at amortized cost each period using the effective interest method. For guidance on amortization/accretion in subsequent periods, see section 3.5 (subsequent measurement of debt instruments) and Questions 3.4.80 to 3.4.100 (determining the amortization period).



Question 10.4.20
How are debt issuance costs accounted for when they relate to debt issued at a substantial premium?

Interpretive response: There is no specific guidance that addresses allocating debt issuance costs between the equity component (i.e. the substantial premium) and the debt component.

We believe the following are acceptable accounting policies for allocating those costs (but other approaches may also be acceptable):

- allocating the costs between the debt and equity components proportionately based on the allocation of proceeds to those components; and
- allocating all debt issuance costs to the debt component.

10.5 No proceeds allocated model

10.5.10 Overview



Excerpt from ASC 470-20

> Convertible Debt Instruments

25-12 A debt with an embedded conversion feature shall be accounted for in its entirety as a liability and no portion of the proceeds from the issuance of the convertible debt instrument shall be accounted for as attributable to the conversion feature unless the conversion feature is required to be accounted for separately as an embedded derivative under Subtopic 815-15 or the conversion feature results in a premium that is subject to the guidance in paragraph 470-20-25-13.

If an instrument is not accounted for under the embedded derivative or substantial premium models, no portion of the proceeds from the issuance of a convertible instrument is ascribed to the conversion feature. [\[470-25-15-12\]](#)



Question 10.5.10

Is a convertible instrument with a cash conversion feature in the scope of the no proceeds allocated model?

Interpretive response: It depends. A cash conversion feature is a feature that permits the issuer to settle a conversion in cash (or other assets), including partial cash settlement. If a convertible instrument with a cash conversion feature is not accounted for under the embedded derivative or substantial premium models, it is accounted for under the no proceeds allocated model. [\[470-20-15-07A, 15-12\]](#)



Example 10.5.10

Cash conversion features

ABC Corp. issues fixed-rate convertible debt instruments with a 20-year maturity for their par value of \$1,000 per bond. A holder has the ability to convert each bond at any time to the equivalent of 10 of ABC's common shares – i.e. the conversion price is \$100 per share (\$1,000 issuance price ÷ 10 shares). On initial issuance of the debt, the market price of ABC's common shares is \$80 per share. The debt instruments include a cash conversion feature (described below) and do not provide for adjustment of the conversion feature, other than standard anti-dilution provisions.

The conversion feature is not required to be separately accounted for as a derivative under Topic 815. Further, the convertible debt was issued at par and,

as a result, it is not accounted for under the substantial premium model. Therefore, the convertible debt is in the scope of the no proceeds allocated model.

A holder elects to convert when the market price of ABC's common shares is \$200 per share. At that time, the following amounts are determined:

- If-converted value is \$2,000: Each debt instrument's if-converted value is \$2,000, calculated as the 10 shares to which the bond is convertible × the market price of \$200 per share.
- Conversion spread is \$1,000: Each debt instrument's conversion spread is \$1,000, calculated as the excess of the \$2,000 if-converted value over the \$1,000 par value.

The following are examples of cash conversion features.

Cash conversion feature	Explanation
ABC is permitted to satisfy its obligation either by delivering the full stated number of shares or by delivering cash equal to the if-converted value.	The feature permits ABC to settle the instrument in cash on conversion. On conversion, ABC is permitted to satisfy its obligation by delivering: <ul style="list-style-type: none"> — 10 shares of its stock; or — \$2,000 cash for the if-converted value.
ABC is required to satisfy the principal amount (or accreted value) in cash and the conversion spread in shares.	The feature requires ABC to partially settle the instrument in cash on conversion. On conversion, ABC is required to deliver: <ul style="list-style-type: none"> — \$1,000 cash for the principal amount; and — 5 shares to satisfy the conversion spread, (\$1,000 conversion spread ÷ \$200 market price per share).
ABC is required to satisfy the principal amount (or accreted value) in cash and can elect to satisfy the conversion spread in either cash or shares.	The feature requires ABC to either fully or partially settle the instrument in cash on conversion. On conversion, ABC is required to deliver: <ul style="list-style-type: none"> — \$1,000 cash for the principal amount; and — to satisfy the conversion spread, ABC may choose to deliver \$1,000 cash or 5 shares (\$1,000 conversion spread ÷ \$200 market price per share).
ABC is permitted to satisfy its obligation by delivering any combination of shares or cash equal to the if-converted value.	The feature permits ABC to either fully or partially settle the instrument in cash on conversion. On conversion, ABC is permitted to satisfy its obligation through delivering any combination of cash or shares having a value equal to the \$2,000 if-converted value.

In addition to these examples, convertible debt instruments may contain other terms that require or permit the issuer to deliver cash (or other assets) on exercise of an embedded conversion option.



Question 10.5.20

Is a convertible instrument that is (or has the potential to be) in-the-money when it is issued in the scope of the no proceeds allocated model?

Interpretive response: Yes. If such a convertible instrument is not accounted for under the embedded derivative or substantial premium models, it is accounted for under the no proceeds allocated model. [470-20-15-12]



Example 10.5.20

Convertible debt issued with in-the-money conversion feature

ABC Corp. issues a series of 20-year convertible bonds each with a \$1,000 par value for \$800. Each bond is convertible to 40 ABC common shares – i.e. the conversion price is \$20 per share ($\$800 \text{ issuance price} \div 40 \text{ shares}$). The fair value of ABC common shares on the issuance date is \$25 per share. As a result, the conversion feature is in-the-money when it is issued. The bonds do not provide for adjustment of the conversion feature, other than standard anti-dilution provisions.

The conversion feature is not required to be separately accounted for as a derivative under Topic 815. Further, the convertible bonds were issued at a discount and, as a result, they are not accounted for under the substantial premium model. Therefore, the convertible bonds are in the scope of the no proceeds allocated model.



Example 10.5.30

Convertible instrument with conversion feature that will be in-the-money based on the passage of time

ABC Corp. issues at par a convertible note with a principal amount of \$1 million. The note can initially be converted to 100,000 ABC common shares – i.e. the initial conversion price is \$10 ($\$1,000,000 \text{ issuance price} \div 100,000 \text{ shares}$), which is also the fair value of ABC common shares on the issuance date. That is, the initial conversion price is at-the-money.

The note includes a following multiple-step discounts based on the initial conversion price:

- 15% after three years
- 25% after six years
- 35% after nine years
- 40% after 10 years.

The fair value of ABC common shares on the issuance date is \$10 per share. Therefore, if the note is converted after six years, the conversion price is lowered to \$7.50 ($\$10 \text{ initial conversion price less the } 25\% \text{ discount}$) and the

holder receives 133,333 shares on conversion. That is, the conversion feature will become in-the-money (as compared to the underlying share's fair value when the convertible note was issued) with the passage of time.

The bonds do not provide for any other adjustment of the conversion feature, other than standard anti-dilution provisions.

The conversion feature is not required to be separately accounted for as a derivative under Topic 815. Further, the convertible debt was issued at par and, as a result, it is not accounted for under the substantial premium model. Therefore, the convertible debt is in the scope of the no proceeds allocated model.



Example 10.5.40

Convertible instrument that may become in-the-money due to down-round feature

On January 1, Year 4, ABC Corp. issues at par a five-year convertible note with a \$1 million principal amount. The note is convertible to 100,000 ABC common shares – i.e. the conversion price is \$10 per share (\$1 million issuance price ÷ 100,000 shares). The fair value of ABC common shares on that date is \$10. Therefore, the initial conversion option is at-the-money.

The debt instrument contains a down-round feature that specifies that if ABC issues common shares at a price less than \$10 per share, the conversion price adjusts to 90% of that issue price. Therefore, the conversion feature will be in-the-money when the down-round feature is triggered.

The bonds do not provide for any other adjustment of the conversion feature, other than standard anti-dilution provisions.

The conversion feature is not required to be separately accounted for as a derivative under Topic 815. Further, the convertible note was issued at par and, as a result, it is not accounted for under the substantial premium model. Therefore, the convertible note is in the scope of the no proceeds allocated model.

10.5.20 Recognition and initial measurement



Excerpt from ASC 470-20


> Convertible Debt Instruments

25-15 If the issuance transaction for a convertible debt instrument within the scope of this Subtopic includes other unstated (or stated) rights or privileges in addition to the convertible debt instrument, a portion of the initial proceeds shall be attributed to those rights and privileges based on the guidance in other applicable U.S. generally accepted accounting principles (GAAP).

When no proceeds are allocated to the conversion feature, a convertible instrument is recorded as debt on issuance at the full amount of the issuance proceeds, unless other applicable GAAP requires allocation of proceeds to unstated (or stated) rights or privileges. [470-20-25-15]

Examples of how to record such an instrument are also in the following.

- Recording debt on issuance, Example 10.5.50 and section 3.3.
- Recording equity-classified preferred shares on issuance, section 5.4.

 **Example 10.5.50**
Convertible debt issued with no proceeds allocated to the conversion feature

ABC Corp. issues a series of 20-year convertible bonds each with a \$1,000 par value for \$1,000. ABC also pays \$50 in issuance costs per bond to third parties other than the holders.

Each bond is convertible to 40 ABC common shares. The fair value of ABC common shares at the issuance date is \$20 per share.

The conversion option is in the scope of the no proceeds allocated model. It is not separately accounted for as a derivative and each bond is issued for its principal amount (and therefore not at a substantial premium).

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	
Bonds payable – Debt issuance costs	50	
Cash (paid to third parties)		50
Bonds payable		1,000
<i>To recognize issuance of bonds.</i>		

 **Question 10.5.30**
How is a debt instrument recognized when it is convertible to shares of a subsidiary and no proceeds are allocated to its conversion option?

Interpretive response: When a debt instrument is convertible to shares of a subsidiary and none of the proceeds are allocated to its conversion option, the instrument is recorded as a liability on issuance at the full amount of the issuance proceeds. [470-20-25-12, 810-10-45-17A]

In contrast, Topic 810 (consolidation) requires an embedded feature that is separately recorded in equity under applicable US GAAP to be presented as a

component of NCI in the consolidated financial statements if it is in the scope of paragraph 815-40-15-5C; this is regardless of whether the instrument was entered into by the parent or the subsidiary. See further discussion in section 8.2.30. [810-10-45-17A]



Example 10.5.60

Debt convertible to shares of a consolidated subsidiary

ABC Corp. issues a series of bonds each with a par value of \$1,000. Each bond is convertible to 50 shares of Sub at a conversion price of \$20 per share. Sub is a consolidated subsidiary of ABC and is considered a substantive entity.

The conversion option is in the scope of the no proceeds allocated model – i.e. it is not separately accounted for as a derivative and was not issued at a substantial premium.

ABC records the following journal entry for each bond issued.

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

10.5.30 Subsequent measurement



Excerpt from ASC 470-20

> Interest Forfeiture

05-9 When a convertible debt instrument is converted to equity securities, sometimes the terms of conversion provide that any accrued but unpaid interest at the date of conversion is forfeited by the former debt holder. This occurs either because the conversion date falls between interest payment dates or because there are no interest payment dates (a zero coupon convertible debt instrument).

> Interest Expense

35-6 Subtopic 835-10 provides overall guidance on accretion and amortization of debt premium or discount and debt issuance costs. This guidance addresses the incremental matter related to interest forfeiture.

35-11 If the terms of conversion of a convertible debt instrument provide that any accrued but unpaid interest at the date of conversion is forfeited by the former debt holder, that interest should be accrued or imputed to the date of conversion of the debt instrument.

A convertible instrument is recorded at amortized cost each period if: [470-20-25-12]

- no proceeds were allocated to the conversion feature or other embedded features when the instrument was issued; and
- the fair value option has not been elected (see Questions 2.3.10 and 9.3.30).

Any discount or premium on the instrument is amortized/accreted over its term using the effective interest method. For guidance on amortization/accretion in subsequent periods, see section 3.5 related to debt instruments and section 5.4 related to equity-classified preferred shares.

Further, with regard to the instrument's stated interest rate and any payments required under the terms of the instrument, if any accrued but unpaid interest at conversion is to be forfeited by the former debt holder under the instrument's terms, the interest is still accrued or imputed to the conversion date. Section 10.7.10 discusses the treatment of accrued interest on the date of conversion. [470-20-35-11]



Question 10.5.40

How does an entity initially measure PIK instruments newly issued as dividends or interest?

Background: Certain convertible instruments have terms that allow for an issuer to pay the interest or dividends with the same convertible instruments as those in the original issuance instead of paying cash. These are referred to as paid-in-kind or PIK instruments.

Interpretive response: We believe it is appropriate to measure the newly issued instrument at its fair value on the dividend declaration (or interest accrual date), regardless of whether the convertible instrument is liability- or equity-classified. This is similar to the accounting for stock dividends under Topic 505 (see section 5.7.30). [505-20-30-3]

However, when the original and newly issued convertible instruments are both in the scope of the no proceeds allocated model – and the following conditions are met – we believe it is also acceptable to measure the newly issued instrument based on the originally issued convertible instrument's contractual rate:

- neither the entity nor the holder can elect other forms of payment – i.e. the dividend or interest is nondiscretionary; and
- the originally issued convertible instrument was issued at (or near) the amount on which the PIK dividend or interest is determined and all issuance proceeds were allocated to it. For example, if PIK interest is determined for a convertible debt instrument based on its principal amount of \$1,000, the instrument is issued for proceeds of (or near) \$1,000 with all proceeds allocated to it.

When these conditions are met, the originally issued convertible instrument is similar to a zero coupon instrument because the issuer does not transfer assets in satisfaction of any contractual dividend or interest amounts until the originally

issued convertible instrument is redeemed or matures. Therefore, we believe it is acceptable to measure newly issued PIK instruments (i.e. those issued as periodic dividends or interest) based on their contractual rate, which has a result similar to applying the effective interest method to the originally issued convertible instrument.

An entity with PIK instruments that meet the above conditions should apply its policy for measuring PIK interest or dividends consistently.



Example 10.5.70

Measurement of PIK dividends on equity-classified convertible preferred shares

ABC Corp. issues 1,000 preferred shares at their liquidation preference of \$10 per share. The shares are convertible to common shares on a one-for-one basis and are equity-classified. Dividends must be paid in kind if and when declared by ABC's board of directors at a rate of 10% per annum based on the liquidation preference (i.e. 100 convertible preferred shares of \$10 per share).

The convertible instrument is in the scope of the no proceeds allocated model and all issuance proceeds were allocated to the original convertible instrument.

On the date ABC declares the first PIK dividends, the fair value of the convertible preferred shares is \$16 per share.

Measurement of PIK instrument and related dividend cost on first declaration date


The newly issued PIK instrument is in the scope of the no proceeds allocated model. Because the PIK dividends are nondiscretionary (see Question 10.5.40) and the original convertible preferred shares were issued at their liquidation preference of \$10 per share, ABC may elect to measure the newly issued PIK instruments based on:

- the fair value of the newly issued PIK instrument on the dividend declaration date; or
- the contractual rate of the originally issued convertible preferred shares (10%).

These amounts are calculated as follows.

Fair value of preferred shares as of the date the dividend is declared	\$ 16	
Number of preferred shares issued in dividend	100	
Total dividend based on <i>fair value</i> of preferred shares on the declaration date		\$1,600

Par value per preferred share	\$ 10
Number of preferred shares originally issued	1,000
Total par value of preferred shares originally issued	\$10,000
Contractual dividend rate	10%
Total dividends based on contractual rate of preferred shares	\$1,000

 **Question 10.5.50**
How does the trigger of a down-round feature impact subsequent measurement of temporary equity-classified convertible preferred shares?

 **Excerpt from ASC 260-10**

30-1 As of the date that a **down round feature** is triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price) in an equity-classified freestanding **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance), an entity shall measure the value of the effect of the feature as the difference between the following amounts determined immediately after the down round feature is triggered:

- a. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the currently stated strike price of the issued instrument (that is, before the strike price reduction)
- b. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the reduced strike price upon the down round feature being triggered.

30-2 The fair values of the financial instruments in paragraph 260-10-30-1 shall be measured in accordance with the guidance in Topic 820 on fair value measurement. See paragraph 260-10-45-12B for related **earnings per share** guidance and paragraphs 505-10-50-3 through 50-3A for related disclosure guidance.

35-1 An entity shall recognize the value of the effect of a **down round feature** in an equity-classified freestanding **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) each time it is triggered but shall not otherwise subsequently remeasure the value of a down round feature that it has recognized and measured in accordance with paragraphs 260-10-25-1 and 260-10-30-1 through 30-2. An entity shall not subsequently amortize the amount in additional paid-in capital arising from recognizing the value of the effect of the down round feature.

Background: A down-round feature is a provision in an equity-linked financial instrument that reduces the strike price of the instrument if the entity:

- sells additional shares of its common stock for an amount less than the current strike price of the instrument; or
- issues another equity-linked financial instrument with a strike price that is less than the currently stated strike price of the instrument.

When a down-round is triggered, whether an issuer measures and recognizes the effect of the down-round feature depends on the instrument. [260-10-25-1, 35-1, 45-12B, ASU 2020-06.BC62]

- **Equity-classified convertible preferred share (unless the conversion feature has been bifurcated).** The issuer recognizes the effect of the down-round feature as an increase in APIC and a decrease in retained earnings – i.e. as a deemed dividend, including when determining income available to common shareholders in basic EPS. The issuer does not subsequently amortize the amount in APIC and also does not remeasure the down-round feature (unless the feature is subsequently triggered).
- **Convertible debt instrument or liability-classified convertible preferred share.** The effect of the down-round feature is not measured and recognized. This is because an entity discloses fair value information for these instruments (see section 10.9.50), and changes in the down-round feature (such as a trigger) should be inherently captured in the fair value measure.

See section 6.18.20 of KPMG Handbook, [Earnings per share](#), for guidance.

Question 8.8.150 further discusses down-round features and how they differ from standard antidilution provisions. Question 8.8.160 explains that a down-round feature does not in and of itself cause an instrument (or embedded feature) to fail the indexation guidance.

Interpretive response: When a convertible preferred share is classified in temporary equity, the issuer may be required to subsequently remeasure the instrument; chapter 7 discusses SEC guidance on redeemable equity-classified instruments. When remeasuring a convertible preferred share that is classified in temporary equity, the SEC staff will object to an issuer considering the amount in APIC related to the value of the effect of the down-round feature that was previously triggered. This is because the issuer is prohibited from amortizing that amount. [260-10-35-1]

Nevertheless, the amount in APIC represents part of the convertible preferred share's carrying amount when determining if there is a difference between the net carrying amount and the redemption amount to be recognized in retained earnings if and when the share is extinguished (i.e. repurchased or redeemed). [260-10-S99-2]



Example 10.5.80

Redemption of convertible preferred shares classified in temporary equity

On January 1, Year 1, Issuer issues at par \$50 million of convertible preferred shares that pay dividends at a rate of 10% of par value per year. The convertible preferred shares are:

- redeemable for their par amount plus accrued (but unpaid) dividends at the option of Holder on any date after December 31, Year 3; and
- convertible to 5 million of Issuer’s common shares – i.e. the conversion price is \$10 per share (\$50 million issuance price ÷ 5 million common shares). The convertible preferred shares include a down-round feature that specifies that if Issuer issues common shares at a price less than \$10 per share, the conversion price adjusts to that issue price.

Issuer concludes the preferred shares are in scope of the ‘no proceeds allocated’ convertible instrument model. Issuer classifies the preferred shares in temporary equity because of Holder’s redemption option. Further, because it is probable that the preferred shares will become redeemable (i.e. they are redeemable with the passage of time), Issuer elects to measure the preferred shares using the accretion model (Model 2); see Question 7.4.10.

In both scenarios, Issuer does not pay accrued dividends in any period before Holder elects to redeem all shares on January 1, Year 4.

Scenario 1: Down-round is never triggered

The journal entries at the relevant dates are below.

January 1, Year 1

	<i>Debit</i>	<i>Credit</i>
Cash	50,000,000	
Temporary equity ¹		50,000,000
<i>To recognize issuance of convertible preferred shares.</i>		
Note:		
1. The preferred shares are initially measured at fair value (see section 7.4.20).		

December 31 of each of Year 1, Year 2 and Year 3

	<i>Debit</i>	<i>Credit</i>
Retained earnings (deemed dividend) ¹	5,000,000	
Temporary equity ²		5,000,000
<i>To recognize accretion of change in redemption amount.</i>		

Notes:

1. Issuer has a surplus of retained earnings and therefore dividends (including deemed dividends) are recorded as a reduction of retained earnings.
2. \$50 million par amount × 10% dividend rate per year.

January 1, Year 4

	<i>Debit</i>	<i>Credit</i>
Temporary equity ¹	65,000,000	
Cash		65,000,000
<i>To recognize Holder's redemption of convertible preferred shares.</i>		
Note:		
1. \$50 million par amount + (\$5 million unpaid dividends per year × 3 years).		

In this scenario, the convertible preferred stock's carrying amount is equal to the redemption amount when it is redeemed. As a result, there is no difference to recognize in retained earnings at that time.

Scenario 2: Down-round is triggered on January 1, Year 2

On January 1, Year 2, Issuer issues common shares for an issuance price of \$8 per share. Under their down-round feature, this results in the convertible preferred shares' conversion price being adjusted to \$7.20. Issuer measures the effect of the down-round being triggered as \$4 million (assumed).

The journal entries at the relevant dates are below.

January 1 and December 31, Year 1

Same entries as in Scenario 1.

January 1, Year 2

	<i>Debit</i>	<i>Credit</i>
Retained earnings (deemed dividend) ¹	4,000,000	
APIC		4,000,000
<i>To recognize effect of down-round feature being triggered.</i>		
Note:		
1. Issuer has a surplus of retained earnings and therefore dividends (including deemed dividends) are recorded as a reduction of retained earnings.		

December 31 of each of Year 2 and Year 3

Same entries as in Scenario 1. Although APIC was credited by \$4 million when the down-round was triggered on January 1, Year 2, that amount is not subsequently amortized – i.e. is not considered when the instrument is subsequently remeasured.

January 1, Year 4

	<i>Debit</i>	<i>Credit</i>
Cash ¹	65,000,000	
APIC	4,000,000	
Temporary equity		65,000,000
Retained earnings (deemed contribution)		4,000,000
<i>To recognize Holder's redemption of convertible preferred shares.</i>		
Note:		
1. \$50 million par amount + (\$5 million unpaid dividends per year × 3 years).		

In this scenario, the convertible preferred stock's carrying amount (including the amount credited to APIC for the value of the effect of the down-round feature) is not equal to the redemption amount when it is redeemed. As a result, the difference is recognized in retained earnings. In addition, this difference results in a positive adjustment (deemed contribution) when computing basic EPS; see section 3.3.50 of KPMG Handbook, [Earnings per share](#), for guidance.

10.6 Modifications and extinguishments

Subtopic 470-20 does not provide specific guidance on determining the accounting for a modification or exchange of a convertible instrument. Instead, an entity must look to other applicable guidance. See chapter 5 for modifications and extinguishments of equity-classified preferred shares, and chapter 4 for other convertible instruments.

For convertible instruments other than equity-classified preferred shares, the guidance in Subtopic 470-50 is used to determine the accounting for a modification or exchange of a convertible instrument, including whether a modification is accounted for as an extinguishment. Under that guidance the following changes related to an embedded conversion option result in the modification being accounted for as an extinguishment without regard to other terms of the modification, unless the convertible debt instrument is in the scope of the embedded derivative model. [\[470-50-40-10 – 40-11\]](#)

- The terms of a debt instrument are modified or exchanged, and this affects the terms of an embedded conversion option, such that the change in the embedded conversion option's fair value is at least 10% of the carrying amount of the original debt immediately before the modification or exchange.
- The modification or exchange of debt instruments adds or eliminates a substantive conversion option.

For further discussion on whether modifications or exchanges of convertible instruments result in modification or extinguishment accounting (including changes to the embedded conversion option), see Questions 4.4.30 to 4.4.50.

When the guidance in Subtopic 470-50 does not apply, the guidance in paragraph 405-20-40-1 is applied to determine whether a repayment that is not a conversion by the holder represents an extinguishment. However, inducement accounting may apply in certain circumstances when the instrument is settled (see section 10.8).

See also:

- section 4.5.20 about modifications and exchanges of convertible debt when extinguishment accounting is applied
- section 4.10.20 about extinguishments of convertible debt instruments;
- section 4.6.20 about modification accounting for convertible debt

10.7 Conversions (other than induced conversions)

10.7.10 Substantial premium and no proceeds allocated models



Excerpt from ASC 470-20

> Contractual Conversion

40-4 If a convertible debt instrument accounted for in its entirety as a liability under paragraph 470-20-25-12 is converted into shares, cash (or other assets), or any combination of shares and cash (or other assets), in accordance with the conversion privileges provided in the terms of the instrument, upon conversion the carrying amount of the convertible debt instrument, including any unamortized premium, discount, or issuance costs, shall be reduced by, if any, the cash (or other assets) transferred and then shall be recognized in the capital accounts to reflect the shares issued and no gain or loss is recognized.

> Interest Forfeiture

40-11 If the terms of conversion of a convertible debt instrument provide that any accrued but unpaid interest at the date of conversion is forfeited by the former debt holder, accrued interest from the last interest payment date, if applicable, to the date of conversion, net of related income tax effects, if any, shall be charged to interest expense and credited to capital as part of the cost of securities issued. Thus, the accrued interest is accounted for in the same way as the principal amount of the debt converted and any unamortized premium, discount, or issuance costs; the net carrying amount of the debt, including any unamortized premium, discount, or issuance costs and the related accrual for interest to the date of conversion, net of any related income tax effects, is a credit to the entity's capital.

On conversion of a convertible instrument accounted for under the substantial premium or no proceeds allocated model, a physically settled convertible debt instrument or convertible preferred share is derecognized. Simple conversion accounting is applied on the conversion of such an instrument; Question 10.7.10 discusses instruments accounted for under the substantial premium


model. This is the case even if the convertible instrument includes a cash conversion feature and the issuer uses cash or other assets in settlement (or partial settlement) of the conversion. [470-20-40-4]

Under conversion accounting, an entity increases its equity at conversion by an amount equal to the carrying amount of the convertible instrument. The carrying amount includes: [470-20-40-4, 40-11]

- any unamortized premium or discount and unamortized issuance costs; and
- the related accrued interest expense to the date of conversion if the terms of the conversion provide that accrued interest (unpaid at the date of conversion) is forfeited (i.e. when the accrued amount will not be paid in cash).

No gain or loss is recognized when conversion occurs based on the original terms of a convertible instrument. [470-20-40-4, 40-11]

However, that conversion accounting does not apply when the conversion option has been bifurcated as an embedded derivative at any time before conversion, including when a conversion feature is bifurcated and subsequently reclassified to equity (or vice versa). See section 10.7.20 for guidance in that situation.

 **Example 10.7.10**
Conversion of debt to common shares

On January 1, Year 4, ABC Corp. issues a series of 20-year bonds each with a \$1,000 par value for \$900 each. Each bond is convertible to 50 ABC common shares with a par value of \$1 per share. The conversion feature does not require bifurcation as a derivative and the bonds were issued at a discount (i.e. not a substantial premium). The bonds have an 8% coupon rate and cash interest payments are made annually on January 1.

For simplicity, this example does not reflect debt issuance costs.

ABC records the following journal entry for each bond issued.

	<i>Debit</i>	<i>Credit</i>
Cash (received from issuance)	900	
Bonds payable – Discount on bonds payable	100	
Bonds payable		1,000
<i>To recognize issuance of bond.</i>		

On December 31, Year 8, a holder converts a bond into ABC common shares. At the conversion date, the fair value of ABC common shares is \$35 per share. Further, the bond’s carrying amount totals \$992, which consists of:

- accreted value of \$912: \$900 initial carrying amount + five years of discount accretion under the effective interest method as described in Topic 835; and

- \$80 of accrued interest payable: \$1,000 par value × 8% coupon rate (one year is accrued because annual interest was due the day after the conversion occurred). The holder is not entitled to receive this amount in cash on conversion (i.e. it is forfeited).

ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Bonds payable	1,000	
Accrued interest payable	80	
Bonds payable – Discount ¹		88
Common shares ²		50
APIC ³		942
<i>To recognize conversion of bonds.</i>		
Notes:		
1. \$1,000 par value of bond less the \$912 accreted value.		
2. 50 shares at \$1 par value.		
3. \$912 accreted value of the bond + \$80 of accrued interest payable – \$50 par value of shares issued.		

ABC does not record the common shares at their \$1,750 fair value on conversion (i.e. 50 shares × fair value of \$35 per share) and does not record a gain or loss because the debt is converted based on the terms of the original debt agreement.



Example 10.7.20

Conversion of debt to common shares (cash conversion feature)

On January 1, Year 1, ABC Corp. issues a series of 1,000 fixed-rate bonds with a 20-year maturity. The bonds were issued for their aggregate par amount of \$1,000,000. The bonds 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 if-converted value); an instrument with this feature is commonly referred to as 'Instrument X'.

The bonds do not contain embedded features other than the conversion option.

The debt is not measured at fair value. The conversion feature does not require bifurcation as an embedded derivative. Because the debt was issued at its principal amount, it was not issued at a substantial premium.

For simplicity, this example does not reflect debt issuance costs.

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>		

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.

ABC records the following journal entry to recognize interest expense for each of Years 1 through 4.

	<i>Debit</i>	<i>Credit</i>
Interest expense	40,000	
Cash ¹		40,000
<i>To recognize interest expense on convertible bonds.</i>		
Note:		
1. \$1,000,000 principal amount × 4% stated coupon interest rate.		

On January 1, Year 5, the conversion option is exercised by all holders of the convertible bonds. At the conversion date, the fair value of ABC common shares is \$75 per share. Therefore, 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.

Scenario 1: ABC settles the conversion entirely with shares

ABC records the following journal entry to recognize the conversion.

	<i>Debit</i>	<i>Credit</i>
Bonds payable	1,000,000	
Common shares ¹		20,000
APIC ²		980,000
<i>To recognize conversion of bonds.</i>		
Notes:		
1. 1,000 bonds × 20 shares at \$1 par value.		
2. \$1,000,000 principal amount of the bonds less the \$20,000 par value of common shares.		

ABC does not record the common shares at their \$1,500,000 fair value on conversion and does not record a gain or loss because the debt is converted based on the terms of the original debt agreement.

Scenario 2: ABC settles the principal amount in cash and the conversion spread in shares

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 spread. ABC records the following journal entry to recognize the conversion.

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

Scenario 3: ABC settles the conversion entirely in cash

ABC records the following journal entry to recognize the conversion.

	<i>Debit</i>	<i>Credit</i>
Bonds payable	1,000,000	
APIC ¹	500,000	
Cash		1,500,000
<i>To recognize conversion of bonds.</i>		
Note:		
1. Represents the \$500,000 conversion spread.		



Question 10.7.10

Does conversion accounting apply to an instrument in scope of the substantial premium model?

Interpretive response: Yes. We believe conversion accounting applies in this situation because the conversion feature is treated as an equity component instead of a separately recorded liability. As a result, conversion of the instrument pursuant to its contractual terms should not result in a gain or loss being recognized in the entity's income statement. [470-20-40-4]



Question 10.7.20

Does conversion accounting apply when a nonbifurcated conversion option is exercised but the debt instrument also has other embedded features that have been bifurcated?

Interpretive response: Yes. For some convertible instruments, an embedded feature other than the conversion option (e.g. embedded call option, embedded put option, contingent payment feature) might require bifurcation and separate accounting as a derivative asset or liability under Topic 815.

If a nonbifurcated conversion option embedded within a host debt instrument (or preferred share) is exercised and the bifurcated embedded derivative asset or liability expires unexercised, we believe conversion accounting should apply to all components of the original debt instrument (or preferred share). [470-20-40-4]



Example 10.7.30

Conversion of debt with a separately recorded embedded put option derivative

On January 1, Year 4, ABC Corp. issues a series of 20-year bonds each with a \$1,000 par value for \$1,000. Each bond is convertible to 50 ABC common shares with a par value of \$1 per share.

If the S&P 500 Index achieves 5% growth over a six-month period, the holder of the bonds has the ability to put the bonds to ABC for 120% of the par value of the bonds plus cash equal to the increase in the S&P 500 Index over that six-month period. The put option meets the criteria for bifurcation as a derivative and is recorded at fair value on issuance of the bonds, while the conversion option is accounted for under the no proceeds allocated to equity model.

For simplicity, this example does not reflect unamortized debt issue costs.

The fair value of the put feature is \$50 on the issuance date. The bonds have an 8% coupon rate and cash interest payments are made annually on January 1.

ABC records the following journal entry for each bond issued.

	<i>Debit</i>	<i>Credit</i>
Cash (received from issuance)	1,000	
Bonds payable – Discount on bonds payable	50	
Put option liability		50
Bonds payable		1,000
<i>To recognize issuance of bond.</i>		

On January 1, Year 9, the put option becomes exercisable because the S&P 500 achieved growth of 5% over the prior six-month period. A holder instead chooses to convert a bond to ABC common shares. At the conversion date:

- the bond has an accreted value of \$956: \$950 initial carrying amount + five years of discount accretion under the effective interest method as described in Topic 835;
- the fair value of the put option is \$10; and
- the fair value of ABC common shares is \$35 per share.

ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Bonds payable	1,000	
Put option liability ¹	10	
Bonds payable – Discount on bonds payable ²		44
Common shares ³		50
APIC ⁴		916
<i>To recognize conversion of bond.</i>		
Notes:		
1. The put option liability is measured at fair value, with changes in fair value reported in earnings, prior to conversion.		
2. Par value of bond (\$1,000) – Accreted value of bond (\$956).		
3. 50 shares at \$1 par value.		
4. Net carrying amount of bond plus the put option (\$956 + \$10 = \$966) less the \$50 par value of the shares issued.		

ABC does not record the common shares at their \$1,750 fair value on conversion (50 shares × fair value of \$35 per share) and does not record a gain or loss because the debt is converted based on the terms of the original debt agreement.



Question 10.7.30

Does conversion accounting apply to the conversion of stock-settled debt?

Interpretive response: No. Stock-settled debt is debt that permits or requires settlement by the issuer’s delivery of a variable number of its own equity shares with a monetary value that is predominantly based on a fixed amount (see Question 10.2.30).

Because the value of the holders’ payoff from such a share settlement feature is not affected by the issuer’s share price (i.e. the feature cannot be in-the-money), we believe this feature generally does not embody a conversion option as contemplated by Subtopic 470-20. This generally is the appropriate conclusion regardless of the terminology used in the related debt agreement, such as labeling the fixed-value share settlement feature as a conversion option. Therefore, we believe the settlement of a debt obligation should generally be accounted for as an extinguishment when the settlement is in

exchange for the delivery of a variable number of shares predominantly based on a fixed monetary amount.

Section 6.9 for guidance on accounting for stock-settled debt and certain other freestanding financial instruments that permit or require settlement in a variable number of the entity's own equity shares (see Question 10.7.10).

10.7.20 Embedded derivative model



Question 10.7.40

Does conversion accounting apply when a conversion option is accounted for separately as a derivative at the date of conversion?

Interpretive response: No. When an embedded conversion option is accounted for separately as a derivative under Topic 815 at the date of conversion, we believe the debt (or preferred share) no longer contains a conversion feature for accounting purposes. Therefore, if the holder exercises the separately accounted for conversion option, we believe the entity should apply extinguishment accounting for the debt (or preferred share) and the separately accounted for conversion option, instead of conversion accounting. [\[470-20-40-4\]](#)

Under extinguishment accounting, the entity records a gain or loss (or a return to preferred shareholders) on extinguishment equal to the difference between:

- the fair value of the common shares issued or other consideration paid at the date of extinguishment; and
- the aggregate carrying amount of the debt (or preferred shares) and the separately accounted for conversion option.

We believe an entity should apply extinguishment accounting whenever the conversion option is accounted for separately as a derivative at the time of the conversion. This includes when the conversion option is initially *not* bifurcated because it qualifies for equity classification at the convertible instrument's initial recognition, and subsequently *is* bifurcated because it ceases to qualify for equity classification.



Example 10.7.40

Conversion of debt with a separately recorded derivative for the conversion feature to common shares

On January 1, Year 4, ABC Corp. issues a series of 20-year bonds each with a \$1,000 par value for \$1,000. Each bond is convertible to 50 ABC common shares with a par value of \$1 per share, but the conversion option cannot be exercised until the S&P 500 Index achieves 5% growth over a six-month period.

Because the conversion feature cannot be exercised until a contingent event occurs, and that contingent event is based on an observable market, the conversion option is bifurcated and recorded at fair value on issuance of the bonds.

The fair value of the conversion feature is \$50 on the issuance date. The bonds have an 8% coupon rate and cash interest payments are made annually on December 31.

For simplicity, this example does not reflect unamortized debt issue costs.

ABC records the following journal entry for each bond issued.

	<i>Debit</i>	<i>Credit</i>
Cash (received from issuance)	1,000	
Bonds payable – Discount on bonds payable	50	
Conversion option liability		50
Bonds payable		1,000
<i>To recognize issuance of bond.</i>		

On January 1, Year 9, the conversion option becomes exercisable because the S&P 500 achieved 5% growth over the prior six-month period. A holder converts a bond to ABC common shares. At the conversion date:

- the bond has an accreted value of \$956: \$950 initial carrying amount + five years of discount amortization under the effective interest method as described in Topic 835;
- the fair value of the conversion option is \$765; and
- the fair value of ABC common shares is \$35 per share.

ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Bonds payable	1,000	
Loss on extinguishment ¹	29	
Conversion option liability ²	765	
Bonds payable – Discount on bonds payable ³		44
Common shares ⁴		50
APIC ⁵		1,700
<i>To recognize conversion of bond.</i>		

Notes:

1. Difference between the net carrying amount of the bond and the conversion option ($\$956 + \$765 = \$1,721$) and the fair value of the common shares issued ($50 \text{ shares} \times \$35 \text{ per share} = \$1,750$).
2. The conversion option liability is measured at fair value, with changes in fair value reported in earnings, prior to conversion.
3. Par value of bond ($\$1,000$) – Accreted value of bond ($\$956$).

4. 50 shares at \$1 par value.
5. Fair value of the common shares issued (\$1,750) less the \$50 par value of the shares issued.



Question 10.7.50

How is a conversion accounted for when the conversion feature previously was accounted for as a derivative but is subsequently reclassified as to equity?



Excerpt from ASC 815-15

- > Option is Exercised

40-1 If a holder exercises a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to paragraph 815-15-35-4, the issuer shall recognize any unamortized discount remaining at the date of conversion immediately as interest expense.

Background: Topic 815 requires assessment of embedded features for bifurcation on an ongoing basis. As a consequence, an embedded feature that was previously determined to be a derivative requiring bifurcation may subsequently cease to require bifurcation. For further guidance on reassessing embedded derivatives in subsequent periods, see sections 9.5.30 and 9.5.40.

Interpretive response: Subtopic 815-15 addresses a situation in which the conversion feature in convertible debt (or preferred share) is bifurcated as a derivative but subsequently qualifies for equity classification. In those cases, the fair value of the conversion feature at the date the criteria for equity classification are met is reclassified to equity. The debt (or preferred share) host is unaffected and continues to be accounted for on an amortized cost basis. [815-15-35-4, 815-40-35-10]

Subsequently, if the instrument is converted (i.e. when the conversion feature is classified in equity), any unamortized discount on the debt (or preferred share) is recorded as interest expense (or return to preferred shareholders) before reclassification to equity. There is not otherwise a gain or loss (or return to preferred shareholders) related to the difference between the fair value of the shares and the carrying amount of the debt and conversion feature. [815-15-40-1]

Question 4.10.60 discusses the accounting treatment for an extinguishment of a convertible instrument with a bifurcated conversion feature that was subsequently reclassified to equity.

10.7.30 Conversion when issuer exercises call option



Excerpt from ASC 470-20

> Conversion Upon Issuer's Exercise of Call Option

05-11 An entity may issue equity securities to settle a debt instrument that was not otherwise currently convertible but became convertible upon the issuer's exercise of a call option when the issuance of equity securities is pursuant to the instrument's original conversion terms. This Subtopic provides related guidance.

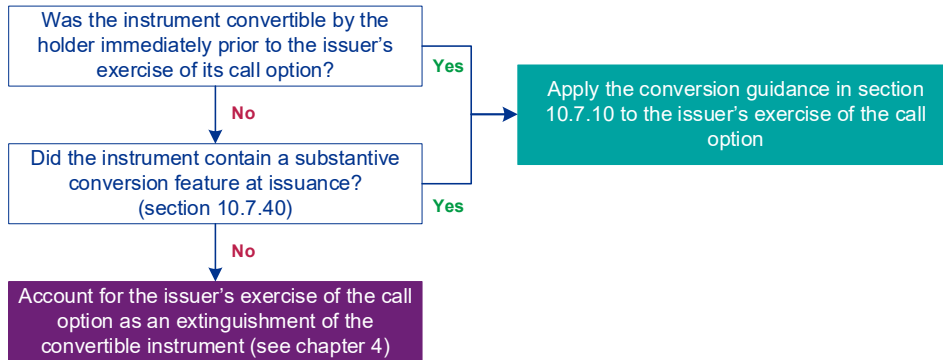
> Conversion upon Issuer's Exercise of Call Option

40-5 The following guidance addresses accounting for the issuance of equity securities to settle a debt instrument (pursuant to the instrument's original conversion terms) that became convertible upon the issuer's exercise of a call option:


- a. **Substantive conversion feature.** If the debt instrument contained a substantive conversion feature as of **time of issuance**, the issuance of equity securities shall be accounted for as a contractual conversion. That is, no gain or loss shall be recognized related to the equity securities issued to settle the instrument.
- b. No substantive conversion feature. If the debt instrument did not contain a substantive conversion feature as of time of issuance, the issuance of equity securities shall be accounted for as a debt extinguishment. That is, the **fair value** of the equity securities issued should be considered a component of the reacquisition price of the debt.

Some instruments that are not otherwise currently convertible become convertible by the holder if the issuer exercises a call option on the instrument. If an instrument has such a feature, the issuance of equity securities in settlement of the instrument is accounted for as a conversion only if the conversion feature was substantive when it was issued. This is the case even if the convertible instrument included other conversion features that were not exercisable at the time of the issuer's call, including a conversion feature that would have become exercisable based on the passage of time. [\[470-20-40-5\]](#)

The following decision tree summarizes the key considerations in determining the appropriate accounting for a conversion on the issuer's exercise of its call option (when the conversion feature has not been bifurcated as a derivative – see Question 10.7.40).



Example 9 of Subtopic 470-20 (see excerpt below) illustrates an example of an instrument subject to this guidance. In that example, the debt instrument contains a substantive conversion feature as of its issuance date. As a result, the issuance of equity securities is accounted for as a conversion with no gain or loss recognized related to the equity securities issued to settle the instrument.


 **Excerpt from ASC 470-20**

- > Example 9: Illustration of a Conversion of an Instrument that Becomes Convertible Upon the Issuer’s Exercise of a Call Option

55-67 This Example illustrates an instrument subject to the guidance in paragraphs 470-20-40-5 through 40-9.

55-68 An entity issues a contingently convertible instrument on January 1, 2006, with a market price trigger, a \$1,000 par amount, and a maturity date of December 31, 2020. The debt instrument is convertible at the option of the holder if the share price of the issuer exceeds a specified amount. The issuer can call the debt at any time between 2009 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the call amount or a fixed number of shares as specified in the terms of the instrument upon issuance, regardless of whether the market price trigger has been met. In 2010, the issuer calls the debt before the market price trigger being met and the holder elects to receive a fixed number of shares (as specified in the terms of the instrument).

10.7.40 Determining whether a conversion feature is substantive

 **Excerpt from ASC 470-20**

- > Conversion upon Issuer’s Exercise of Call Option

40-6 The assessment of whether the conversion feature is substantive may be

performed after time of issuance but shall be based only on assumptions, considerations, and marketplace information available as of time of issuance.

• > Determining Whether a Conversion Feature Is Substantive

40-7 By definition, a substantive conversion feature is at least **reasonably possible** of being exercised in the future. If the conversion price of an instrument at issuance is extremely high so that conversion of the instrument is not deemed at least reasonably possible as of time of issuance, then the conversion feature would not be considered substantive.

40-8 For purposes of determining whether a conversion feature is reasonably possible of being exercised, the assessment of the holder's intent is not necessary. Therefore, even if such an instrument included a conversion feature that provided for conversion due solely to the passage of time (for example, the instrument will become convertible at a date before its maturity date), it would be inappropriate to conclude that the conversion feature is substantive. Also, an instrument that became convertible only upon the issuer's exercise of its call option does not possess a substantive conversion feature.

40-9 Methods that may be helpful in assessing whether a conversion feature is substantive include the following:

- a. The fair value of the conversion feature relative to the fair value of the debt instrument. Comparing the fair value of a conversion feature to the fair value of the debt instrument (that is, the complete instrument as issued) may provide evidence that the conversion feature is substantive.
- b. The effective annual interest rate per the terms of the debt instrument relative to the estimated effective annual rate of a nonconvertible debt instrument with an equivalent expected term and credit risk. Comparing the effective annual interest rate of the debt instrument to the effective annual rate the issuer estimates it could obtain on a similar nonconvertible instrument may provide evidence that a conversion feature is substantive.
- c. The fair value of the debt instrument relative to an instrument that is identical except for which the conversion option is not contingent. Comparing the fair value of the debt instrument to the fair value of an identical instrument for which conversion is not contingent isolates the effect of the contingencies and may provide evidence about the substance of a conversion feature. If the fair value of the debt instrument is similar to the fair value of an identical convertible debt instrument for which conversion is not contingent, then it may indicate that the conversion feature is substantive. However, this approach may not be appropriate unless it is clear that the conversion feature, not considering the contingencies, is substantive.
- d. Qualitative evaluation of the conversion provisions. The nature of the conditions under which the instrument may become convertible may provide evidence that the conversion feature is substantive. For example, if an instrument may become convertible upon the occurrence of a specified contingent event, the likelihood that the contingent event will occur before the instrument's maturity date may indicate that the conversion feature is substantive. However, this approach may not be appropriate unless it is clear that the conversion feature, not considering the contingencies, is substantive.

40-10 The guidance in paragraphs 470-20-40-7 through 40-9 does not address the treatment of an instrument for purposes of applying Subtopic 260-10.

For a conversion feature to be substantive, it must be at least reasonably possible that it will be exercised in the future. [470-20-40-7]

Because the issuer controls when and if it will exercise a call option, it is permitted to perform the assessment of whether the conversion feature is substantive after the instrument is issued. However, the assessment is required to be performed based on the assumptions, considerations and marketplace information available as of the issuance date. [470-20-40-6]



Question 10.7.60

How is the 'reasonably possible' standard applied?

Interpretive response: Subtopic 470-20 identifies four possible methods that may be helpful in assessing whether it is reasonably possible that a conversion feature will be exercised and therefore is substantive, which are summarized as follows. [470-20-40-8 – 40-9]

- Compare the fair value of the conversion feature to the fair value of the entire instrument.
- Compare the effective interest rate of the entire instrument to a rate the issuer could obtain on a similar nonconvertible instrument with an equivalent expected term and credit risk.
- If the conversion feature of a contingently convertible instrument without the contingency would be considered substantive, compare the fair value of the entire instrument to the fair value of an instrument that is identical except for which the conversion option is not contingent. This approach evaluates whether the contingency results in an otherwise substantive conversion feature being nonsubstantive.
- Perform a qualitative evaluation of the conversion provisions.

The underlying question in those methods is whether the conversion feature has any value to the holder of the instrument. Generally, the ability to convert a convertible instrument into an ownership interest of an entity has value to the holder because an owner of the entity gets to participate in the earnings of the entity and because of the potential for growth in the value of that interest. Therefore, an entity will generally be able to conclude that it is reasonably possible that the conversion feature will be exercised in the future, and the conversion feature is substantive.

However, judgment may be required in circumstances when there appears to be no economic value associated with the conversion option. This may include scenarios in which the conversion option is so far out-of-the-money on the issuance date that it is not reasonably possible that the holder would exercise the conversion option during the term of the instrument.

10.8 Induced conversions

10.8.10 Identifying an induced conversion



Excerpt from ASC 470-20

> Induced Conversions

05-10 Some convertible debt instruments include provisions allowing the debtor to alter terms of the debt to the benefit of debt holders. In some circumstances, conversion privileges for a convertible debt instrument are changed or additional consideration is paid to debt holders for the purpose of inducing prompt conversion of the debt to equity securities (sometimes referred to as a convertible debt sweetener). Such provisions may be general in nature, permitting the debtor or trustee to take actions to protect the interests of the debt holders, or they may be specific, for example, specifically authorizing the debtor to temporarily reduce the conversion price for the purpose of inducing conversion.

> Induced Conversions

40-13 The guidance in paragraph 470-20-40-16 applies to conversions of convertible debt to equity securities pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. That guidance applies only to conversions that both:

- a. Occur pursuant to changed conversion privileges that are exercisable only for a limited period of time (inducements offered without a restrictive time limit on their exercisability are not, by their structure, changes made to induce prompt conversion)
- b. Include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted, regardless of the party that initiates the offer or whether the offer relates to all debt holders.

40-14 A conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt. The preceding paragraph also includes conversions pursuant to amended or altered conversion privileges on such instruments, even though they are literally provided in the terms of the debt at issuance.

40-15 The changed terms may involve any of the following:

- a. A reduction of the original conversion price thereby resulting in the issuance of additional shares of stock
- b. An issuance of warrants or other securities not provided for in the original conversion terms
- c. A payment of cash or other consideration to those debt holders that convert during the specified time period.

The guidance in the following paragraph does not apply to conversions pursuant to other changes in conversion privileges or to changes in terms of convertible debt instruments that are different from those described in this paragraph.

40-16 If a convertible debt instrument is converted to equity securities of the debtor pursuant to an inducement offer (see paragraph 470-20-40-13), the debtor shall recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. The fair value of the securities or other consideration shall be measured as of the date the inducement offer is accepted by the convertible debt holder. That date normally will be the date the debt holder converts the convertible debt into equity securities or enters into a binding agreement to do so. Until the debt holder accepts the offer, no exchange has been made between the debtor and the debt holder. Example 1 (see paragraph 470-20-55-1B) illustrates the application of this guidance.

40-17 The guidance in the preceding paragraph does not require recognition of gain or loss with respect to the shares issuable pursuant to the original conversion privileges of the convertible debt when additional securities or assets are transferred to a debt holder to induce prompt conversion of the debt to equity securities. In a conversion pursuant to original conversion terms, debt is extinguished in exchange for equity pursuant to a preexisting contract that is already recognized in the financial statements, and no gain or loss is recognized upon conversion.

An entity may offer additional consideration to the holder of a convertible debt instrument for a limited time to induce conversion of the instrument. The additional consideration (often referred to as a 'sweetener') may include:

- a reduction to the original conversion price;
- the issuance of warrants or other securities not required by the original terms of the debt instrument; or
- a cash payment.

A conversion is subject to inducement accounting if the conversion involves the payment of additional consideration and meets the following criteria: [\[470-20-40-13\]](#)

- the conversion occurs based on changed conversion privileges that are exercisable only for a limited time; and
- the conversion includes the issuance of all of the equity securities issuable based on the conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted, regardless of the party that initiates the offer or whether the offer relates to all holders.

There is no exception to inducement accounting when conversion is induced on debt that is convertible to equity shares whose fair value is less than the conversion price. See Example 1, Case B from Subtopic 470-20 at the end of this section for an example of that circumstance.



Question 10.8.10

Is there a maximum time period for determining what constitutes a limited period of time?

Background: A conversion is subject to inducement accounting if it occurs based on changed conversion privileges that are exercisable only for a limited time. This is the first criterion. [\[470-20-40-13\]](#)

Interpretive response: No. Determining whether changed conversion terms can be exercised for a limited time when evaluating the first criterion for inducement accounting requires considering the specific facts and circumstances of the inducement.

In some circumstances, it is clear that changed conversion terms can be exercised only for a limited time. For example, an exchange offer is made through a formal process with a specified period during which debt holders can convert the debt under the modified terms, and that period is significantly shorter than the remaining term of the instruments subject to the exchange offer.

In other circumstances, it is clear that a change in conversion terms has not been offered for a limited time, such as when a permanent modification to the conversion terms of an instrument is executed.

Because there is no maximum time period or other bright line for determining what constitutes a limited time, judgment is required.



Question 10.8.20

How can a transaction qualify as an induced conversion if there is no formal documentation indicating that the offer was for a limited time?

Background: A conversion is subject to inducement accounting if it occurs based on changed conversion privileges that are exercisable only for a limited time. This is the first criterion. [\[470-20-40-13\]](#)

Interpretive response: When a holder or a group of holders approaches an entity with an offer to convert its convertible debt instruments under modified terms, a final exchange agreement may be executed shortly after the final terms of the exchange are agreed to between the parties. Because of the nature of the negotiations, no formal documentation may exist to show that the last offer made by one of the parties before acceptance by the counterparty was a limited-time offer.

In the absence of formal documentation, we believe applicable laws governing those negotiations should be considered. For example, if one of the parties makes an offer that does not specify the period during which it can be accepted and applicable laws enable the offer to be rescinded before acceptance (or before execution of the related exchange offer documents), we believe the changed conversion terms are exercisable for a limited time and the first criterion for inducement accounting is met.



Question 10.8.30

Does an induced conversion have to involve the legal exercise of an instrument's contractual conversion privileges?

Background: A conversion is subject to inducement accounting if it includes the issuance of all of the equity securities issuable based on the conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted, regardless of the party that initiates the offer or whether the offer relates to all holders. This is the second criterion. [470-20-40-13]

Interpretive response: No. To meet the second criterion for inducement accounting, a conversion needs to include an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration. However, that exchange does not need to constitute a legal exercise of the contractual conversion privileges included in the terms of the debt instrument.



Example 10.8.10

Party initiating the offer

Inducement accounting applies to all conversions of convertible debt that meet the two criteria, regardless of the party that initiates the offer or whether the offer relates to all debt holders.

Scenario 1: Issuer initiates tender offer

The issuer undertakes a tender offer to all of its convertible debt holders under which each holder can elect, for a limited time, to tender the debt in exchange for all of the equity securities issuable based on the conversion privileges included in the terms of the debt plus additional consideration.

Scenario 2: Holders initiate the offer

A particular convertible debt holder (or group of holders) approaches the issuer with a limited-time offer to exchange all or a specified amount of the debt that the holder(s) currently holds in exchange for all of the equity securities issuable based on the conversion privileges plus additional consideration.

Analysis

Both of these scenarios meet the inducement accounting criteria, even though the inducement offer in the second scenario is initiated by the holder(s) (rather than the issuer) and does not involve all of the debt holders.



Question 10.8.40
How does an issuer determine whether inducement accounting applies to settlement of a convertible instrument with a cash conversion feature?

Background: Some convertible instruments include cash conversion features that permit the issuer to settle a conversion in cash (or other assets), including partly in cash. This includes cash conversion features that permit the issuer to settle a conversion by delivering cash, common shares, or any combination thereof with an aggregate value equal to the if-converted value; an instrument with this feature is commonly referred to as ‘Instrument X’.

Interpretive response: Assuming the conversion occurs based on changed conversion privileges that are exercisable only for a limited time, we believe inducement accounting applies when settlement includes issuance of all contractually required consideration based on the conversion privileges included in the original terms of the convertible instrument – even if the contract does not require the issuer to issue shares in settlement.

This is because conversion accounting applies to settlements of instruments with cash conversion features, including those that an issuer may elect to settle entirely in cash rather than shares. Therefore, if a convertible instrument’s terms permit the issuer to settle a conversion entirely in cash, inducement accounting – i.e. recording an expense on conversion equal to the fair value of the additional consideration offered in addition to applying conversion accounting – may apply even when no equity securities are issued. [470-20-40-4, 40-13]

However, if the form of consideration paid is different from the contractually required form, we believe extinguishment accounting generally would apply. In addition, extinguishment accounting may apply if an issuer repurchases its outstanding debt instruments in the open market at the market price; significant judgment would be required in these situations (see Question 4.4.190). Chapter 4 further discusses extinguishment accounting. See also ‘Future developments’ below about EITF Issue No. 23-A, Induced conversions of convertible debt instruments.



Example 10.8.20
Determining whether inducement accounting applies to a convertible instrument with a cash conversion feature

The following table provides examples of settlement transactions of certain instruments that include a cash conversion feature and whether each constitutes a conversion to which inducement accounting is applied, assuming the conversion occurs based on changed conversion privileges that are exercisable only for a limited time.

Instrument's contractual terms	Settlement transaction	Conversion to which inducement accounting applies?
Any instrument with a cash conversion feature that permits Issuer to settle its obligation entirely in cash	Settled entirely in cash	Yes, because Issuer issued all contractually required consideration. Although no shares were issued, Issuer was not required to issue any equity securities under the instrument's terms.
Issuer required to settle in cash when the conversion option is out-of-the-money	Settled entirely in shares when conversion option is out-of-the-money	No. Because the contractual terms did not permit share settlement, the settlement was not a conversion of the instrument.
Issuer permitted to settle its obligation (or a portion thereof, such as the conversion spread) in any combination of cash and shares – i.e. there is no requirement to settle any portion in shares	Settled partially in shares	Yes, because Issuer issued all contractually required consideration. Although Issuer did not fully settle the conversion in shares, it was not required to settle – fully or partially – in shares.
Issuer is required to settle the principal amount in cash and the conversion spread in shares.	Principal amount settled in cash and conversion spread settled in shares.	Yes, because Issuer settled the principal amount in cash and the conversion spread in shares consistent with the instrument's contractual terms.
Issuer required to settle the principal in cash and the conversion spread in shares.	Settled entirely in shares.	No, because all contractually required consideration was not issued. The contractual terms did not permit share settlement of the principal amount.



Question 10.8.50

How is a change in conversion terms accounted for if it does not satisfy the two inducement accounting criteria?

Interpretive response: If a change in conversion terms does not meet the inducement accounting criteria, the issuer follows other accounting literature applicable to modifications. See section 5.4.60 for modifications of equity-classified preferred shares, and chapter 4 for other convertible instruments.

If a holder elects to convert the instrument under the modified terms, conversion accounting is applied based on the instrument's carrying amount after applying the other accounting literature applicable to modifications (see section 10.6).



Example 10.8.30 Permanent change in conversion price

On January 1, Year 4, ABC Corp. issues at par a series of bonds with a \$1,000 par value. Each bond is convertible to 50 ABC common shares at a conversion price of \$20 per share. The conversion feature is in the scope of the no proceeds allocated model – i.e. there is no separate accounting for the conversion feature.

By January Year 6, the market value of ABC common shares has dropped to \$5 per share. Despite this decline, ABC is not experiencing financial difficulties. ABC and the convertible debt holders execute a modification to the terms of the bonds that permanently lowers the conversion price from \$20 to \$7.

The modification of the debt instrument is not an inducement because the reduction in the conversion price is permanent – i.e. it is not for a limited time as required by the first criterion. Further, the modification is not a TDR because the entity is not experiencing financial difficulties and the holder has not granted a concession related to the issuer's financial difficulties (see section 4.2).

ABC applies the guidance in paragraphs 470-50-40-6 to 40-20 to determine whether the transaction represents a substantial modification of the debt that is accounted for as a debt extinguishment. That guidance also addresses the subsequent accounting for debt modifications (including modifications that increase or decrease the fair value of an embedded conversion option) when extinguishment accounting is not applied (see section 4.4.40).



Future developments#

In April 2023, the EITF added to its agenda Issue No. 23-A, Induced conversions of convertible debt instruments. In September 14, 2023, the EITF reached a consensus-for-exposure on Issue 23-A, which would provide additional guidance on whether induced conversion or extinguishment accounting should be applied to certain settlements of convertible debt instruments that do not occur in accordance with the instruments' preexisting terms.

The consensus-for-exposure was ratified by the Board in October 2023 and was issued as a proposed Accounting Standards Update in December 2023. The proposed ASU would require companies to apply a preexisting contract approach. To qualify for induced conversion accounting under this approach, the inducement offer would need to preserve the form of consideration and result in an amount of consideration that is no less than that issuable pursuant to the preexisting conversion privileges.

The proposed ASU would clarify how companies should assess the form and amount of consideration when applying this approach. In addition, it would clarify that induced conversion accounting can be applied to settlements of certain convertible debt instruments that are not currently convertible. Other than transition disclosures, the proposed ASU does not contemplate any

additional disclosure requirements specific to induced conversions. The comment period ended in March 2024.

10.8.20 Accounting for an induced conversion

When an entity's convertible debt is converted into the entity's equity securities based on an inducement offer meeting the two inducement criteria, the entity records an expense on conversion equal to the fair value of the additional consideration offered. [470-20-40-16]



Question 10.8.60

How is the fair value of additional consideration determined?

Interpretive response: To determine the fair value of the additional consideration, the entity subtracts the fair value of securities issuable to the holder under the original terms of the debt instrument from the total fair value of all securities and other consideration transferred in the transaction. The difference is the amount attributed to the inducement.

The fair values of the securities transferred in the transaction and the securities issuable under the original terms are measured as of the date that the inducement offer is accepted by the holder of the convertible debt. This is typically the date on which the debt is converted or the date that a binding agreement is reached to convert the debt. Examples 10.8.20 to 10.8.40 demonstrate the mechanics of computing the additional consideration. [470-20-40-16]



Question 10.8.70

Does inducement accounting apply to convertible preferred shares?

Interpretive response: Yes. Similar to convertible debt instruments, the guidance on accounting for induced conversions applies to convertible preferred share transactions meeting the inducement accounting criteria. As is the case for convertible debt, inducement accounting applies regardless of whether the entity or the preferred stockholder(s) initiates the transaction and whether the offer relates to all preferred stockholders. [260-10-S99-2]

If an entity is required to account for a change in the conversion terms of convertible preferred shares as an inducement, it records a dividend on the convertible preferred shares equal to the fair value of the additional consideration given to a holder to induce conversion. The additional consideration is the fair value of the consideration given in excess of the fair value of securities issuable based on the original conversion terms. [260-10-S99-2]

That preferred share dividend is reflected as a charge to the numerator in EPS calculations. If only a portion of a class of convertible preferred shares is

converted during a period based on an inducement offer, the potential dilutive effect of each portion should be calculated separately. See section 3.3.50 of KPMG Handbook, [Earnings per share](#), for further guidance.



Example 10.8.40

Conversion induced by reducing conversion price

On January 1, Year 4, ABC Corp. issues at par a series of 20-year convertible bonds each with a \$1,000 par value. Each bond is convertible to 40 ABC common shares with a par value of \$1 at a conversion price of \$25 per share. The conversion feature is in the scope of the no proceeds allocated model – i.e. there is no separate accounting for the conversion feature).

ABC's common shares have no par or stated value.

On January 1, Year 7, the fair value of an ABC convertible bond is \$1,500. To induce holders to convert the bonds to common shares, ABC reduces the conversion price from \$25 per share to \$20 per share for all bonds converted within 30 days. As a result, a holder will receive 50 common shares on conversion of each bond instead of the original 40 shares. The inducement offer is accepted when a bond is converted during the 30-day period.

The change in the conversion price is an inducement because ABC is:

- offering additional consideration to the holders (by increasing the number of shares to be issued on conversion);
- the offer is for a limited time; and
- the transaction includes the issuance of all of the equity shares issuable based on the conversion privileges included in the terms of the debt at issuance.

On January 15, Year 7, a holder converts a bond to ABC common shares when the fair value of the common shares is \$35 per share. ABC records an expense equal to the fair value of the additional consideration on the date the bond is converted to equity, computed as follows.

Number of common shares issued at conversion as a result of the inducement	50	
Fair value of a common share on conversion	× \$35	
Total value to the holder including the inducement		\$1,750
Number of shares issuable under original terms of the bond	40	
Fair value of a common share on conversion	× \$35	
Total value to the holder under the original terms		\$1,400
Additional consideration		\$ 350

ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Bonds payable	1,000	
Debt conversion expense	350	
Common shares ¹		50
APIC ²		1,300
<i>To recognize conversion of bond.</i>		
Notes:		
1. 50 shares × \$1 par value per share.		
2. APIC is increased by the sum of the \$1,000 carrying amount of the debt and the \$350 fair value of the additional consideration (i.e. 10 incremental shares) less the \$50 par value of the common shares (\$1,000 + \$350 – \$50 = \$1,300). ABC does not record the common shares at the \$1,750 total fair value of the 50 shares delivered on conversion.		



Example 10.8.50

Conversion induced by increasing interest rate

On January 1, Year 4, ABC Corp. issues at par a series of convertible bonds each with a \$1,000 par value. The bonds mature on January 1, Year 9 and each bond is convertible to 50 ABC common shares with a par value of \$1 at a conversion price of \$20 per share. The conversion feature is in the scope of the no proceeds allocated model – i.e. there is no separate accounting for the conversion feature.

The bonds have an 8% coupon rate and cash interest payments are made annually on January 1. The terms of the debt instrument specify that on conversion ABC is required to pay cash interest from the date of the last interest payment to the conversion date.

ABC's common shares have no par or stated value.

On September 15, Year 8, ABC offers to increase the interest rate to 12% if a holder converts a bond within 60 days. The higher interest rate applies to the period from the date of the last interest payment (January 1, Year 8) to the date of conversion. ABC intends to induce prompt conversion of the bonds to equity by providing the incentive. The inducement offer is accepted when the conversion option is exercised within the 60-day period.

The increase in the interest rate is an inducement because the increased interest represents additional consideration that is only available for a limited time and the transaction includes the issuance of all of the equity shares issuable under the conversion privileges included in the terms of the debt at issuance. ABC records the additional interest as an expense on the conversion date.

On November 1, Year 8, a holder accepts the offer and converts a bond on that date. The increased interest applies for a period of 10 months – i.e. from the

date of the last interest payment on January 1, Year 8 to the date of conversion on November 1, Year 8. ABC's common share price on conversion is \$25 per share.

ABC computes the additional consideration as follows.

Fair value of shares issued on conversion (50 shares × \$25 per share)	\$ 1,250	
Interest (\$1,000 × 12% × 10/12)	100	
Total value to the holder including the inducement		\$ 1,350
Fair value of shares issued on conversion (50 shares × \$25 per share)	1,250	
Interest (\$1,000 × 8% × 10/12)	67	
Total value to the holder under the original terms		1,317
Additional consideration		\$ 33

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	67	
Accrued interest payable		67
<i>To recognize interest expense at original effective interest rate through conversion.</i>		
Bonds payable	1,000	
Debt conversion expense	33	
Common shares ¹		50
APIC ²		950
Inducement payable		33
<i>To recognize conversion of bond.</i>		
Notes:		
1. 50 shares × \$1 par value per share.		
2. Common shares are increased by the \$1,000 carrying amount of the debt less the \$50 par value of the common shares (\$1,000 – \$50 = \$950). ABC does not record the common shares at the \$1,250 total fair value of the 50 shares delivered on conversion.		



Example 10.8.60

Conversion induced by increasing the shares to be issued on conversion

On January 1, Year 4, ABC Corp. issues at par a series of 20-year convertible bonds each with a \$1,000 par value. Each bond is convertible to 50 ABC common shares with a par value of \$1 at a conversion price of \$20 per share. The conversion feature is in the scope of the no proceeds allocated model – i.e. there is no separate accounting for the conversion feature. The bonds have an 8% coupon rate and cash interest payments are made annually on January 1.

ABC's common shares have no par or stated value. ABC records the following journal entry on issuance of each bond.

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

On January 1, Year 8, ABC changes the original conversion price to induce prompt conversion. ABC agrees to exchange a bond for 60 common shares if a holder converts within the next 30 days.

The change in the conversion price is an inducement because ABC is offering additional consideration to holders (by increasing the number of shares to be issued on conversion), the offer is for a limited time, and the offer applies to the issuance of all of the equity shares issuable under the conversion privileges included in the terms of the debt at issuance.

On January 1, Year 8, a holder accepts the offer and converts a bond into 60 common shares. The fair value of ABC common shares on January 1, Year 8 is \$30 per share. ABC records an expense equal to the fair value of the additional consideration, computed as follows.

Number of common shares issued at conversion as a result of the inducement	60		
Fair value of a common share on conversion	× \$30		
Total value to the holder including the inducement			\$ 1,800
Number of shares issuable under original terms of the bond	50		
Fair value of a common share on conversion	× \$30		
Total value to the holder under the original terms			\$ 1,500
Additional consideration			\$ 300

ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Bonds payable	1,000	
Debt conversion expense	300	
Common shares ¹		60
APIC ²		1,240
<i>To recognize conversion of bond.</i>		
Notes:		
1. 60 shares × \$1 par value per share.		
2. APIC is increased by the sum of the \$1,000 carrying amount of the debt and the \$300 fair value of the additional consideration (i.e. 10 incremental shares) less the \$60 par value of the common shares (\$1,000 + \$300 – \$60 = \$1,240). ABC does not record the common shares at the \$1,800 total fair value of the 60 shares delivered on conversion.		



Example 10.8.70

Induced conversion of debt in the scope of the cash conversion subsections

On January 1, Year 4, ABC Corp. issues 100,000 convertible notes at their par value of \$1,000 per note, raising total proceeds of \$100 million. The notes bear interest at a fixed rate of 2% per annum, payable annually in arrears on December 31. The notes are scheduled to mature 20 years from the issuance date.

Each \$1,000 par value note is convertible at any time to the equivalent of 10 ABC common shares – i.e. the conversion price is \$100 per share (\$1,000 issuance price ÷ 10 shares). On conversion, ABC can elect to settle the entire if-converted value (i.e. the par value of the debt plus the conversion spread) in cash, shares or any combination thereof. The conversion feature does not require bifurcation as a derivative and is in the scope of the no proceeds allocated model.

In December Year 8, ABC reduces the conversion price from \$100 per share to \$80 for all notes converted within 30 days. Under the offer, a holder that accepts the offer receives 12.5 common shares on conversion of each bond instead of the original 10 shares (\$1,000 issuance price per note ÷ \$80 per share revised conversion price).

On January 1, Year 9, when the fair value of ABC's common shares is \$140 per share, all of the holders of convertible notes accept the offer and convert their notes. The total value of consideration received by those holders on conversion is \$175 million ((\$100 million principal ÷ \$80 conversion price) × \$140 share price).

For simplicity, transaction costs have been omitted from this example.

Initial recognition and measurement

ABC records the following journal entry at initial recognition.

	<i>Debit</i>	<i>Credit</i>
Cash (received from issuance)	100,000,000	
Notes payable		100,000,000
<i>To recognize issuance of debt.</i>		

Subsequent measurement

During the five-year period from January 1, Year 4 to December 31, Year 8, ABC recognized total interest expense of \$10 million. Because the notes were issued at their par amount, the contractual interest rate equals the effective interest rate for accounting purposes.

The following journal entry summarizes the amounts recorded by ABC from January 1, Year 4 to December 31, Year 8.

	<i>Debit</i>	<i>Credit</i>
Interest expense	10,000,000	
Cash ¹		10,000,000
<i>To recognize interest expense on debt.</i>		
Note:		
1. \$100 million principal amount × 2% per year × 5 years.		

Derecognition

The change in the conversion price is subject to inducement accounting because (see Question 10.8.40):

- the conversion occurs based on changed conversion privileges that are exercisable only for a limited time; and
- the conversion includes the issuance of all of consideration issuable based on the conversion privileges included in the terms of the convertible debt at issuance.

This is the case regardless of whether ABC elects to settle the conversion with shares, cash or a combination thereof.

ABC is offering additional consideration to the holders (by reducing the conversion price from \$100 per note to \$80) and the offer is for a limited time. Therefore, the amount of the debt conversion expense to be recognized is computed as follows.

Total if-converted value to the holders including the inducement: (\$100 million ÷ \$80) × \$140	\$175,000,000
Total if-converted value to the holders under the original terms: (\$100 million ÷ \$100) × \$140	140,000,000
Debt conversion expense	<u>\$ 35,000,000</u>

The three scenarios that follow illustrate the potential accounting to be applied depending on which of the three potential alternatives ABC chooses as the settlement method.

Scenario 1: Payment of principal in cash and conversion spread in shares

ABC records the following journal entry on conversion of the bonds on January 1, Year 9 assuming it elects to transfer consideration to the holder in the form of \$100 million cash for the principal amount and 535,714 common shares with a fair value of \$75 million (535,714 shares × \$140 fair value per common share) for the conversion spread.

	<i>Debit</i>	<i>Credit</i>
Notes payable	100,000,000	
Debt conversion expense	35,000,000	
Common shares at par ¹		5,357
APIC ²		34,994,643
Cash		100,000,000
<i>To recognize settlement of notes subject to inducement accounting.</i>		
Notes:		
1. 535,714 total shares issued × \$0.01 par value per share.		
2. \$100 million carrying amount of debt + \$35 million debt conversion expense – \$100 million cash issued – \$5,357 par value of shares issued.		

Scenario 2: Settlement in shares only

ABC records the following journal entry on conversion of the bonds on January 1, Year 9 assuming it elects to transfer consideration to the holder in the form of 1.25 million common shares (with a fair value of \$175 million).

	<i>Debit</i>	<i>Credit</i>
Notes payable	100,000,000	
Debt conversion expense	35,000,000	
Common shares at par ¹		12,500
APIC ²		134,987,500
<i>To recognize settlement of notes subject to inducement accounting.</i>		
Notes:		
1. 1.25 million total shares issued × \$0.01 par value per share.		
2. \$100 million carrying amount of debt + \$35 million debt conversion expense – \$12,500 par value of shares issued.		

Scenario 3: Settlement in cash only

ABC records the following journal entry on conversion of the bonds on January 1, Year 9, assuming it elects to transfer consideration to the holder in the form of \$175 million cash.

	<i>Debit</i>	<i>Credit</i>
Notes payable	100,000,000	
APIC ¹	40,000,000	
Debt conversion expense	35,000,000	
Cash		175,000,000
<i>To recognize settlement of notes subject to inducement accounting.</i>		
Note:		
1. \$175 million cash issued – \$100 million carrying amount of debt – \$35 million debt conversion expense.		

Example 1, Case B from Subtopic 470-20 provides an example of a conversion induced by reducing the conversion price when the fair value of the shares issued on conversion is less than the debt's principal amount.



Excerpt from ASC 470-20

> Illustrations

• > Example 1: Induced Conversions of Convertible Securities

55-1B The following Cases illustrate application of the guidance in paragraph 470-20-40-16 to induced conversions of convertible securities:

- a. Reduced conversion price for conversion before determination date, increase in bond **fair value** (Case A)
- b. Reduced conversion price for conversion before determination date, decrease in bond fair value (Case B).

55-2 For simplicity, the face amount of each security is assumed to be equal to its carrying amount in the financial statements (that is, no original issue premium or discount exists).

•• > Case A: Reduced Conversion Price for Conversion before Determination Date—Bond Fair Value Increased

55-3 On January 1, 19X4, Entity A issues a \$1,000 face amount 10 percent convertible bond maturing December 31, 20X3. The carrying amount of the bond in the financial statements of Entity A is \$1,000, and it is convertible into common shares of Entity A at a conversion price of \$25 per share. On January 1, 19X6, the convertible bond has a fair value of \$1,700. To induce convertible bondholders to convert their bonds promptly, Entity A reduces the conversion price to \$20 for bondholders that convert before February 29, 19X6 (within 60 days).

55-4 Assuming the market price of Entity A's common stock on the date of conversion is \$40 per share, the fair value of the incremental consideration paid by Entity A upon conversion is calculated as follows for each \$1,000 bond that is converted before February 29, 19X6.

Value of securities issued ^(a)	\$ 2000
Value of securities issuable pursuant to original conversion privileges ^(b)	<u>1,600</u>
Fair value of incremental consideration	<u>\$ 400</u>
 (a) Value of securities issued to debt holders is computed as follows:	
Face amount	\$ 1,000
÷ New conversion price	÷ <u>\$ 20</u> per share
Number of common shares issued upon conversion	50 shares
× Price per common share	× <u>\$ 40</u> per share
Value of securities issued	<u>\$ 2,000</u>
 (b) Value of securities issuable pursuant to original conversion privileges is computed as follows:	
Face amount	\$ 1,000
÷ Original conversion price	÷ <u>\$ 25</u> per share
Number of common shares issuable pursuant to original conversion privileges	40 shares
× Price per common share	× <u>\$ 40</u> per share
Value of securities issuable pursuant to original conversion privileges	<u>\$ 1,600</u>

55-5 Therefore, Entity A records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

	<u>Debit</u>	<u>Credit</u>
Convertible debt	\$1,000	
Debt conversion expense	400	
Common stock		\$1,400

• • > Case B: Reduced Conversion Price for Conversion before Determination Date—Bond Fair Value Decreased

55-6 On January 1, 19X1, Entity B issues a \$1,000 face amount 4 percent convertible bond maturing December 31, 20X0. The carrying amount of the bond in the financial statements of Entity B is \$1,000, and it is convertible into common shares of Entity B at a conversion price of \$25. On June 1, 19X4, the convertible bond has a fair value of \$500. To induce convertible bondholders to convert their bonds promptly, Entity B reduces the conversion price to \$20 for bondholders that convert before July 1, 19X4 (within 30 days).

55-7 Assuming the market price of Entity B's common stock on the date of conversion is \$12 per share, the fair value of the incremental consideration paid by Entity B upon conversion is calculated as follows for each \$1,000 bond that is converted before July 1, 19X4.

Value of securities issued ^(a)	\$ 600
Value of securities issuable pursuant to original conversion privileges ^(b)	<u>480</u>
Fair value of incremental consideration	<u>\$ 120</u>
 (a) Value of securities issued to debt holders is computed as follows:	
Face amount	\$ 1,000

÷ New conversion price	÷	\$ 20	per share
Number of common shares issued upon conversion		50	shares
× Price per common share	×	\$ 12	per share
Value of securities issued		\$ 600	
 (b) Value of securities issuable pursuant to original conversion privileges is computed as follows:			
Face amount		\$ 1,000	
÷ Original conversion price	÷	\$ 25	per share
Number of common shares issuable pursuant to original conversion privileges		40	shares
× Price per common share	×	\$ 12	per share
Value of securities issuable pursuant to original conversion privileges		\$ 480	

55-8 Therefore, Entity B records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

	Debit	Credit
Convertible debt	\$1,000	
Debt conversion expense	120	
Common stock		\$1,120

55-9 The same accounting would apply if, instead of reducing the conversion price, Entity B issued shares pursuant to a tender offer of 50 shares of its common stock for each \$1,000 bond surrendered to the entity before July 1, 19X4. See paragraph 470-20-40-14.

10.9 Presentation and disclosure

10.9.10 Overview



Excerpt from ASC 470-20

45-1A Transaction costs incurred with third parties other than the investor(s) and that directly relate to the issuance of convertible debt instruments within the scope of this Subtopic shall be reported in accordance with the guidance in Section 835-30-45.

This section addresses the specific presentation and disclosure requirements associated with convertible instruments. These are incremental to the requirements related to debt instruments (see sections 3.6 and 3.8) and equity instruments (see section 5.12).

Third-party issuance costs are accounted for in accordance with Section 835-30-45. See chapter 3 for further guidance on third-party issuance costs.

10.9.20 Balance sheet classification of convertible debt



Excerpt from ASC 470-20

45-1B The guidance on convertible debt instruments in this Subtopic does not affect an issuer’s determination of whether the instruments should be classified as a current liability or a long-term liability. For purposes of applying other applicable U.S. generally accepted accounting principles (GAAP) to make that determination, all terms of the convertible debt instrument shall be considered.

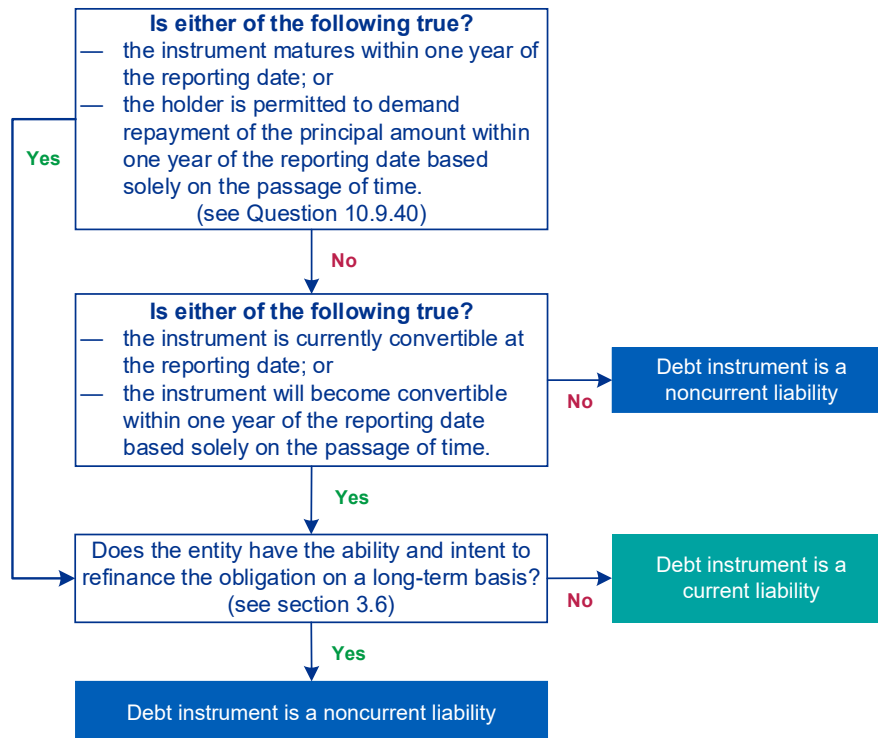
Classification on the balance sheet of an issuer’s obligation under a convertible debt instrument depends on the terms of the instrument. See section 3.6 for guidance about balance sheet classification. [470-20-45-1B]



Question 10.9.10

How is a convertible debt instrument classified when the issuer is required to settle the principal amount in cash, but may settle the conversion spread in either cash or shares?

Interpretive response: The classification model for such an instrument is summarized as follows. [210-10-45-6, 470-10-45-14]





Question 10.9.20

Is a convertible debt instrument classified as a current liability when the principal is required to be cash-settled and the conversion feature is out-of-the-money at the reporting date?

Interpretive response: It depends on whether the instrument is currently convertible (or will become convertible within one year of the reporting date based solely on the passage of time). If so, the instrument is classified as a current liability even if the conversion feature is out-of-the-money at the reporting date. This is because the holder can require the issuer to redeem the debt instrument for cash equal to the if-converted value. Although electing to convert may appear to be an uneconomic choice for the holder when the conversion feature is out-of-the-money at the reporting date, the holder has (or will have) the contractual right to convert. [210-10-45-6]

However, if the issuer has the ability and intent to refinance the obligation on a long-term basis, the obligation is classified as a noncurrent liability; see section 3.6.20 for guidance on whether an issuer has that ability and intent.

Further, if the instrument is not currently convertible (and will not become convertible within one year of the reporting date based solely on the passage of time), the obligation is classified as a noncurrent liability.



Question 10.9.30

How is a convertible debt instrument classified when settlement may be based on a combination of cash and shares?

Interpretive response: The terms of some convertible debt instruments have a cash conversion feature that permits the issuer to settle the if-converted value in a combination of cash and shares. In that situation, the issuer is permitted to consider its intended settlement method when determining the appropriate classification. However, because the issuer cannot be required to deliver cash or other assets on conversion of those instruments – i.e. the issuer is contractually entitled to satisfy conversions through the delivery of its own equity shares – the holder's ability to convert the instruments currently or within 12 months of the reporting date does not cause the instruments to be considered short-term obligations. [210-10-45-6, 470-10-45-9 – 45-10]



Question 10.9.40

How is a convertible debt instrument with a cash conversion feature classified when a put option allows holders to demand repayment within one year of the reporting date?

Interpretive response: A convertible debt instrument with a cash conversion feature is a short-term obligation if the instrument either: [210-10-45-6, 470-10-45-9 – 45-10]

- permits the holder to demand repayment of the principal amount (holder put option) within one year of the reporting date; or
- has a maturity date within one year of the reporting date.

In that circumstance, the debt instrument is presented as a current liability on the issuer's balance sheet unless the issuer has the ability and intent to refinance the obligation on a long-term basis; see section 3.6.20 for guidance on whether an issuer has that ability and intent.



Question 10.9.50

How is a convertible debt instrument classified when a contingent conversion feature is exercisable for a stated period following a contingent event?

Background: For many convertible debt instruments (including those with a cash conversion feature), the conversion feature is only exercisable for a stated period following specified contingent events, such as:

- the issuer's share price exceeding a specified per share amount (market price trigger);
- the convertible debt instrument trading for an amount that is less than a specified percentage of its if-converted value (parity provision); or
- the announcement of a merger involving the issuer.

Interpretive response: A convertible debt instrument is considered to be a short-term obligation when: [210-10-45-6, 470-10-45-9 – 45-10]

- it requires settlement of the principal amount (or accreted value) in cash on conversion; and
- a conversion contingency has been met at the reporting date so the debt is currently convertible or will become convertible within 12 months of the reporting date.

In this circumstance, the convertible debt instrument is presented as a current liability on the issuer's balance sheet unless the issuer has the ability and intent to refinance the obligation on a long-term basis; see section 3.6.20 for guidance on whether an issuer has that ability and intent.



Question 10.9.60

Does meeting a contingency after year-end but before the financial statements are issued cause a convertible debt instrument to be reclassified at the reporting date?

Interpretive response: No. Meeting a conversion contingency event after the reporting date but before the date the financial statements are issued (or are available to be issued) is a nonrecognized subsequent event that does not affect the classification of a convertible debt instrument in the current period. [855-10-25-3]

However, an issuer needs to provide appropriate disclosures about the contingently convertible debt as required by paragraphs 505-10-50-12 to 50-18 and paragraphs 855-10-50-2 to 50-3.



Question 10.9.70

Does current classification of a convertible debt instrument affect its measurement?

Interpretive response: No. The balance sheet classification of a convertible debt instrument does not affect its measurement.

For example, the issuer continues to amortize the debt discount and debt issue costs over the expected life determined at issuance, even if a contingent event occurs before the reporting date that requires the liability component to be reclassified as a current liability (see Question 10.9.50).

10.9.30 Temporary equity classification of equity component

The equity component, if applicable, of a convertible debt instrument is not remeasured as long as it continues to meet the criteria for equity classification in Section 815-40-25. However, SEC registrants (and other entities that elect to follow similar accounting guidance) should also consider the SEC's guidance on classification and measurement of redeemable securities for equity components of convertible debt instruments. See chapter 7, including Question 7.3.70 and sections 7.4.40 to 7.4.50 for discussion about the SEC's classification and measurement of equity components. [470-20-35-17, 480-10-S99-3A]

10.9.40 Classification of the equity component of convertible instruments that are convertible to shares of a consolidated subsidiary

A parent entity may issue an instrument that is convertible to the shares of a consolidated subsidiary, or a consolidated subsidiary may issue a convertible instrument that is convertible to its own shares. When such an instrument is

equity-classified (including an embedded conversion option that is separately recorded in equity), the instrument (or embedded conversion option) is presented as a component of NCI in the consolidated financial statements. This result applies regardless of whether the instrument is entered into by the parent or the subsidiary. [810-10-45-17A, 815-40-15-5C]



Question 10.9.80

When is an equity component presented as a component of NCI?

Interpretive response: If an entity issues an instrument that is convertible to the shares of a consolidated subsidiary, or if a consolidated subsidiary issues an instrument that is convertible to its own shares, the parent entity presents any equity component that is accounted for separately as a component of NCI in the consolidated financial statements – i.e. when a conversion option related to a subsidiary’s shares is required to be separately accounted for in equity because the instrument was issued at a substantial premium. [810-10-45-17A]

Further, if a bifurcated conversion option related to a subsidiary’s shares was previously classified as a liability but no longer meets the criteria to be accounted for as a derivative, it is reclassified to NCI at the fair value of the liability on the date it no longer met the derivative criteria. [810-10-45-17A, 815-40-15-5C]



Question 10.9.90

What is the accounting for the portion of the conversion option that remains in NCI after a convertible instrument is redeemed?

Interpretive response: If a parent issues debt that is convertible to the shares of a consolidated subsidiary and the conversion option is presented as a component of NCI, any amount that remains in equity after the convertible debt instrument is redeemed (i.e. settled for cash) is reclassified from NCI to the controlling interest (e.g. APIC) at that time. [810-10-45-17A]

10.9.50

Disclosures



Excerpt from ASC 470-20

> Convertible Debt Instruments

50-1A The objective of the disclosure about convertible debt instruments is to provide users of financial statements with:

- a. Information about the terms and features of convertible debt instruments
- b. An understanding of how those instruments have been reported in an entity's statement of financial position and statement of financial performance
- c. Information about events, conditions, and circumstances that can affect how to assess the amount or timing of an entity's future cash flows related to those instruments.

50-1B An entity shall explain the pertinent rights and privileges of each convertible debt instrument outstanding, including, but not limited to, the following information:

- a. Principal amount
- b. Coupon rate
- c. Conversion or exercise prices or rates and number of shares into which the instrument is potentially convertible
- d. Pertinent dates, such as conversion date(s) and maturity date
- e. Parties that control the conversion rights
- f. Manner of settlement upon conversion and any alternative settlement methods, such as cash, shares, or a combination of cash and shares
- g. Terms that may change conversion or exercise prices, number of shares to be issued, or other conversion rights and the timing of those rights (excluding standard antidilution provisions)
- h. Liquidation preference and unusual voting rights, if applicable
- i. Other material terms and features of the instrument that are not listed above.

50-1C An entity shall provide the following incremental information for contingently convertible instruments or the instruments that are described in paragraphs 470-20-05-8 through 05-8A:

- a. Events or changes in circumstances that would adjust or change the contingency or would cause the contingency to be met
- b. Information on whether the shares that would be issued if the contingently convertible securities were converted are included in the calculation of diluted earnings per share (EPS) and the reasons why or why not
- c. Other information that is helpful in understanding both the nature of the contingencies and the potential impact of conversion.

50-1D An entity shall disclose the following information for each convertible debt instrument as of each date for which a statement of financial position is presented.

- a. The unamortized premium, discount, or issuance costs and, if applicable, the premium amount recorded as paid-in capital in accordance with paragraph 470-20-25-13
- b. The net carrying amount
- c. For public business entities, the fair value of the entire instrument and the level of the fair value hierarchy in accordance with paragraphs 825-10-50-10 through 50-15.

50-1E An entity shall disclose the following information as of the date of the latest statement of financial position presented:

- a. Changes to conversion or exercise prices that occur during the reporting period other than changes due to standard antidilution provisions

- b. Events or changes in circumstances that occur during the reporting period that cause conversion contingencies to be met or conversion terms to be significantly changed
- c. Number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period
- d. Maturities and sinking fund requirements for convertible debt instruments for each of the five years following the date of most recent statement of financial position presented in accordance with paragraph 470-10-50-1.

50-1F An entity shall disclose the following information about interest recognized for each period for which a statement of financial performance is presented:

- a. The effective interest rate for the period
- b. The amount of interest recognized for the period disaggregated by both of the following (see Example 12 [paragraph 470-20-55-69D] for an illustration of this disclosure requirement):
 - 1. The contractual interest expense
 - 2. The amortization of the premium, discount, or issuance costs.

50-1G If the conversion option of a convertible debt instrument is accounted for as a derivative in accordance with Subtopic 815-15, an entity shall provide disclosures in accordance with Topic 815 for the conversion option in addition to the disclosures required by this Section, if applicable.

50-1H If a convertible debt instrument is measured at fair value in accordance with the Fair Value Option Subsections of Subtopic 825-10, an entity shall provide disclosures in accordance with Subtopic 820-10 and Subtopic 825-10 in addition to the disclosures required by this Section, if applicable.

50-1I An entity shall disclose the following information about derivative transactions entered into in connection with the issuance of convertible debt instruments within the scope of this Subtopic regardless of whether such derivative transactions are accounted for as assets, liabilities, or equity instruments:

- a. The terms of those derivative transactions (including the terms of settlement)
- b. How those derivative transactions relate to the instruments within the scope of this Subtopic
- c. The number of shares underlying the derivative transactions
- d. The reasons for entering into those derivative transactions.

An example of derivative transaction entered into in connection with the issuance of a convertible debt instrument within the scope of this Subtopic is the purchase of call options that are expected to substantially offset changes in the fair value or the potential dilutive effect of the conversion option. Derivative instruments also are subject to the disclosure guidance in Topic 815.

Subtopic 470-20 contains the above disclosure requirements for convertible debt. In addition to these requirements, an entity may also be subject to the following disclosure requirements:

- disclosures in Section 505-10-50, including for contingently convertible securities (see section 5.12.40); and
- EPS disclosures in paragraph 260-10-50-1(c).

The following FASB Examples illustrate certain of Subtopic 470-20’s disclosure requirements.



Excerpt from ASC 470-20

- > Example 11: Disclosure of the Information in the Statement of Financial Position

55-69A This Example provides an illustration of the guidance in paragraph 470-20-50-1D based on the assumption that Entity A is a public business entity and has two convertible debt instruments outstanding as of December 31, 20X7 and 20X6.

55-69B The following illustrates the disclosures in a tabular format.

The following is a summary of Entity A’s convertible debt instruments as of December 31, 20X7 (in thousands).

	Principal Amount	Unamortized Debt Discount and Issuance Costs	Net Carrying Amount	Fair Value	
				Amount	Leveling
1.2% convertible debt due on December 31, 20X8	\$1,000	\$ (18)	\$982	\$1,100	Level 2
Zero-coupon convertible debt due on December 31, 20X9	500	(9)	491	462	Level 3

The following is a summary of Entity A’s convertible debt instruments as of December 31, 20X6 (in thousands).

	Principal Amount	Unamortized Debt Discount and Issuance Costs	Net Carrying Amount	Fair Value	
				Amount	Leveling
1.2% convertible debt due on December 31, 20X8	\$1,000	\$ (35)	\$965	\$1,015	Level 2
Zero-coupon convertible debt due on December 31, 20X9	500	(14)	486	450	Level 3

55-69C The disclosures may be provided alternatively in narrative descriptions.

1.2 Percent Convertible Debt Instrument Due on December 31, 20X8

As of December 31, 20X7, and 20X6, the net carrying amount of the convertible debt instrument was \$982,000 and \$965,000, respectively, with unamortized debt discount and issuance costs of \$18,000 and \$35,000. The estimated fair value (Level 2) of the convertible debt instrument was \$1,100,000 and \$1,015,000, respectively as of December 31, 20X7, and 20X6.

Zero-Coupon Convertible Debt Instrument Due on December 31, 20X9

As of December 31, 20X7, and 20X6, the net carrying amount of the convertible debt instrument was \$491,000 and \$486,000, respectively, with unamortized debt discount and issuance costs of \$9,000 and \$14,000. The estimated fair value (Level 3) of the convertible debt instrument was \$462,000 and \$450,000, respectively, as of December 31, 20X7, and 20X6.

• > Example 12: Disclosure of the Information in the Statement of Financial Performance

55-69D This Example provides an illustration of the guidance in paragraph 470-20-50-1F(b) based on the assumption that Entity A has two convertible debt instruments issued before January 1, 20X5, and still outstanding as of December 31, 20X7.

55-69E The following illustrates the disclosures in a tabular format.

The following provides a summary of the interest expense of Entity A's convertible debt instruments (in thousands).

	Year Ended December 31,		
	20X7	20X6	20X5
Coupon Interest	\$12	\$12	\$12
Amortization of debt discount and issuance costs	22	22	21
Total	\$34	\$34	\$33

55-69F The disclosures may be provided alternatively in narrative descriptions.

For the years ended December 31, 20X7, 20X6, and 20X5, the total interest expense was \$34,000, \$34,000, and \$33,000 with coupon interest expense of \$12,000 for each year and the amortization of debt discount and issuance costs of \$22,000, \$22,000, and \$21,000, respectively.

10.10 Own-share lending arrangements

10.10.10 Overview



Excerpt from ASC 470-20

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance or Other Financing

05-12A An entity for which the cost to an investment banking firm (investment bank) or third-party investors (investors) of borrowing its shares is prohibitive (for example, due to a lack of liquidity or extensive open short positions in the shares) may enter into share-lending arrangements that are executed

separately but in connection with a convertible debt offering. Although the convertible debt instrument is ultimately sold to investors, the share-lending arrangement is an agreement between the entity (share lender) and an investment bank (share borrower) and is intended to facilitate the ability of the investors to hedge the conversion option in the entity's convertible debt.

05-12B The terms of a share-lending arrangement require the entity to issue shares (loaned shares) to the investment bank in exchange for a nominal loan processing fee. Although the loaned shares are legally outstanding, the nominal loan processing fee is typically equal to the par value of the common stock, which is significantly less than the fair value of the loaned shares or the share-lending arrangement. Generally, upon maturity or conversion of the convertible debt, the investment bank is required to return the loaned shares to the entity for no additional consideration.

05-12C Other terms of a share-lending arrangement typically require the investment bank to reimburse the entity for any dividends paid on the loaned shares. Typically, the arrangement precludes the investment bank from voting on any matters submitted to a vote of the entity's shareholders to the extent the investment bank is the owner of the shares.

The guidance in Subtopic 470-20 on own-share lending arrangements applies when an entity enters into a share-lending arrangement in contemplation of a convertible debt offering or other financing and that arrangement is equity-classified.

See Questions 3.4.50 and 5.2.150 in KPMG Handbook, [Earnings per share](#), for guidance on how own-share lending arrangements affect EPS calculations.

10.10.20 Equity classification

An own-share lending arrangement is entered into by an issuer with a third party (generally, an investment bank) in anticipation of a convertible debt offering. As part of the arrangement, the issuer will loan shares to the third party in exchange for a nominal loan processing fee. Although the shares are legally outstanding, the nominal loan processing fee is typically equal to the par value of the common stock, which is less than the fair value of the shares. Generally, at maturity or on conversion of the convertible debt, the third party is required to return the loaned shares to the issuer for no additional consideration.

These arrangements are intended to increase the availability of the issuer's shares and to facilitate the ability of investors to hedge the conversion option in the issuer's convertible debt. For some issuers, the pricing of the convertible debt offering depends on the availability of shares in the market.

In our experience, own-share lending arrangements are usually structured so they qualify for equity classification, but an entity needs to perform the equity classification analysis for its particular arrangement.

To determine if the arrangement qualifies for equity classification, an entity performs the following steps.

Evaluate whether arrangement should be classified as a liability under Topic 480 (see Question 10.10.10)



Evaluate whether requirements for equity classification of Subtopic 815-40 are met (see Question 10.10.20)



Question 10.10.10

How is an own-share lending arrangement evaluated under Topic 480?

Interpretive response: Topic 480 requires certain arrangements to be classified as liabilities if the entity is required to transfer assets or deliver equity shares after the arrangement's inception. In a typical own-share lending arrangement, the counterparty is required to return the shares to the entity over the contract period and the entity has no obligation to transfer assets or issue a variable number of its own equity shares. [480-10-25-8, 25-14]

Therefore, the typical own-share lending arrangement does not meet the criteria to be considered a liability under Topic 480. See sections 6.5 and 6.6 for further guidance on making this evaluation.



Question 10.10.20

How is an own-share lending arrangement evaluated under Subtopic 815-40?

Interpretive response: Subtopic 815-40 requires an arrangement to be classified as a liability if it does not meet the equity classification criteria. The typical own-share lending arrangement meets the criteria to be considered indexed to the entity's own equity shares. Further, on maturity, these arrangements typically require the counterparty to deliver physical shares back to the entity for no additional consideration – i.e. physical settlement for a fixed number of shares. [815-40-15-7, 25-1]

Therefore, these arrangements typically meet both the indexation and settlement criteria for equity classification. See section 8.6 for further guidance on making this evaluation.

10.10.30 Recognition and initial measurement



Excerpt from ASC 470-20

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance

25-20A At the date of issuance, a share-lending arrangement entered into on an entity's own shares in contemplation of a convertible debt offering or other financing shall be measured at fair value (in accordance with Topic 820) and recognized as an issuance cost, with an offset to additional paid-in capital in the financial statements of the entity.

30-26A At the date of issuance, a share-lending arrangement entered into on an entity's own shares in contemplation of a convertible debt offering or other financing shall be measured at fair value in accordance with Topic 820.

On determining that an own-share lending arrangement qualifies for equity classification, an entity records the arrangement at fair value with an offset to APIC. Because the arrangement is considered an issuance cost of the related convertible instrument, the accounting for the cost is consistent with guidance that applies to issuance costs of the related convertible instrument. [470-20-25-20A, 30-26A]

10.10.40 Subsequent measurement



Excerpt from ASC 470-20

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance

35-11A If it becomes **probable** that the counterparty to a share-lending arrangement will default, the issuer of the share-lending arrangement shall recognize an expense equal to the then fair value of the unreturned shares, net of the fair value of probable recoveries, with an offset to additional paid-in capital. The issuer of the share-lending arrangement shall remeasure the fair value of the unreturned shares each reporting period through earnings until the arrangement consideration payable by the counterparty becomes fixed. Subsequent changes in the amount of the probable recoveries should also be recognized in earnings.

If an entity determines that it is probable that the counterparty to the share-lending arrangement will default, the entity is required to recognize an expense for the default. Because an entity may reach this determination before the actual default, it is required to remeasure the fair value of the unreturned shares each period until the actual default occurs. [470-20-35-11A]

10.10.50 Disclosures



Excerpt from ASC 470-20

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance

50-2A An entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing shall disclose all of the following. The disclosures must be made on an annual and interim basis in any period in which a share-lending arrangement is outstanding.

- a. A description of any outstanding share-lending arrangements on the entity's own stock
- b. All significant terms of the share-lending arrangement including all of the following:
 1. The number of shares
 2. The term
 3. The circumstances under which cash settlement would be required
 4. Any requirements for the counterparty to provide collateral.
- c. The entity's reason for entering into the share-lending arrangement
- d. The fair value of the outstanding loaned shares as of the balance sheet date
- e. The treatment of the share-lending arrangement for the purposes of calculating earnings per share
- f. The unamortized amount of the issuance costs associated with the share-lending arrangement at the balance sheet date
- g. The classification of the issuance costs associated with the share-lending arrangement at the balance sheet date
- h. The amount of interest cost recognized relating to the amortization of the issuance cost associated with the share-lending arrangement for the reporting period
- i. Any amounts of dividends paid related to the loaned shares that will not be reimbursed.

50-2B An entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing shall also make the disclosures required by Topic 505.

50-2C In the period in which an entity concludes that it is **probable** that the counterparty to its share-lending arrangement will default, the entity shall disclose the amount of expense reported in the statement of earnings related to the default. The entity shall disclose in any subsequent period any material changes in the amount of expense as a result of changes in the fair value of the entity's shares or the probable recoveries. If default is probable but has not yet occurred, the entity shall disclose the number of shares related to the share-lending arrangement that will be reflected in basic and diluted earnings per share when the counterparty defaults.

The above excerpt from Subtopic 470-20 contains specific disclosure requirements for own-share lending arrangements issued in contemplation of a convertible debt issuance. In addition to these requirements, an entity also may be subject to the following disclosure requirements:

- equity disclosures in Subtopic 505-10-50; and
- EPS disclosures in paragraph 260-10-50-1(c).

11. Comprehensive examples

Detailed contents

New items added to this edition: **

11.1 How the standard works

11.2 Prepaid forward contracts on an entity's own shares

Examples

- 11.2.10 Physically settled prepaid forward contract to repurchase a fixed number of shares
- 11.2.20 Physically settled prepaid forward purchase contract for a variable number of shares
- 11.2.30 Physically settled prepaid forward sale contract for a fixed number of shares
- 11.2.40 Physically settled prepaid forward sale contract for a variable number of shares

11.3 Prepaid written put options on an entity's own shares

Question

- 11.3.10 Can a combination of call options that is economically equivalent to a prepaid written put option be combined into one unit of account?

Examples

- 11.3.10 Prepaid written put option
- 11.3.20 Prepaid written put option structured as two options (purchased call option and written call option)

11.4 Accelerated share repurchase programs

Example

- 11.4.10 Prepaid ASR transaction

11.5 Convertible debt with call spread transactions

Example

- 11.5.10 Convertible debt with capped call option

11.6 Debt automatically exchanged upon next round of equity financing and otherwise convertible

Example

- 11.6.10 Debt that is automatically exchanged upon next round of equity financing and otherwise convertible

11.7 Special-purpose acquisition companies

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- 11.7.10 Does a SPAC record a liability for deferred underwriter fees in connection with its IPO?
- 11.7.20 What are some financial instrument considerations associated with SPAC transactions?

11.8 Tranched preferred shares **

Questions

- 11.8.10 Is a future right or obligation freestanding if it is included in the originally issued preferred shares?
- 11.8.20 Does a pay-to-play provision result in a future right or obligation being considered embedded (rather than freestanding)?

Examples

- 11.8.10 Tranched preferred shares (written call option)
- 11.8.20 Tranched preferred shares with pay-to-play provisions
- 11.8.30 Tranched preferred shares with purchased put option (preferred holders control the board)

11.9 Excise tax on share repurchases **

Questions

- 11.9.10 Is the excise tax a direct and incremental cost of a share repurchase transaction?
- 11.9.20 When is the excise tax recognized?
- 11.9.30 How is an adjustment to the excise tax obligation recognized when multiple classes of common or preferred shares are repurchased during a tax year?
- 11.9.40 How is the excise tax accounted for when the repurchased shares are classified in permanent equity?
- 11.9.50 How is the excise tax accounted for when the repurchased shares are temporary equity-classified preferred or common shares?
- 11.9.60 How is the excise tax accounted for when the repurchased shares are liability-classified?

Examples

- 11.9.10 Repurchase of common shares classified in permanent equity (treasury shares)
- 11.9.20 Repurchase of preferred shares classified in temporary equity
- 11.9.30 Repurchase of mandatorily redeemable shares classified as a liability

11.1 How the standard works

This chapter provides comprehensive examples of instruments that require analysis under multiple chapters in this Handbook.

To properly analyze a financial instrument, it is important to understand all of its terms. Those terms may be reflected in more than one agreement – e.g. a contract may be subject to the terms in an ISDA Master Agreement, supplemental schedules, supplemental amendments, trade confirmations and/or side letters. Section 8.5 discusses identifying a contract's terms.

The examples in this chapter assume that provisions in an ISDA agreement relating to the contract (as amended or revised by the transaction documents) have been analyzed and do not preclude meeting the indexation and classification requirements for equity classification. Questions 8.10.20 and 8.12.30 discuss evaluating those provisions.

While not discussed in this chapter, the following additional guidance may be relevant for the transactions discussed:

- KPMG Handbook, [Accounting for income taxes](#).
- KPMG Handbook, [Earnings per share](#).

11.2 Prepaid forward contracts on an entity's own shares

A prepaid forward contract is a forward contract between two parties (including the entity whose shares are the underlying in the forward contract (the issuer)) in which one party has paid the forward price at inception and the other party must deliver the issuer's shares at a future date for an agreed price.

Because a prepaid forward contract on an entity's own shares is an equity-linked financial instrument for the issuer of the shares, the decision tree in section 2.3.40 is used to identify the applicable guidance by the issuer.

This section illustrates how to analyze several arrangements involving prepaid forward contracts on an entity's own shares.

Type of contract	Description	Reference
Physically settled prepaid forward repurchase contract for a fixed number of shares	Issuer transfers assets at inception of a forward contract to repurchase a fixed number of its equity shares at a future date.	Example 11.2.10
Physically settled prepaid forward purchase contract for a variable number of shares	Issuer transfers assets at inception of a forward contract to repurchase a variable number of its equity shares at a future date.	Example 11.2.20
Physically settled prepaid forward sale contract for a fixed number of shares	Issuer receives assets at inception of a forward contract to issue a fixed number of its equity shares at a future date.	Example 11.2.30
Physically settled prepaid forward sale contract for a variable number of shares	Issuer receives assets at inception of a forward contract to issue a variable number of its equity shares at a future date.	Example 11.2.40



Example 11.2.10

Physically settled prepaid forward contract to repurchase a fixed number of shares

On January 1, Year 1 (inception), Issuer pays \$1,000 cash to enter into a freestanding forward contract to purchase 50 of its own \$1 par common equity shares to be delivered on January 1, Year 2 (maturity).

The contract requires physical settlement. It does not include any exercise contingencies and does not provide for any adjustments to the settlement amount other than standard antidilution provisions.

Evaluating classification under Topic 480

One general scope requirement of Topic 480 is that a financial instrument reflect an obligation of the issuer (see section 6.2.30). In this example, Issuer does not have an obligation because it:

- does not have a conditional or unconditional duty or responsibility to transfer assets to settle the instrument because the assets have already been transferred at inception; and
- will *receive* – rather than *issue* – its equity shares in settlement at maturity.

Therefore, the forward contract is not classified as a liability under Topic 480.

Evaluating classification under Subtopic 815-40

Because the forward contract is outside the scope of Topic 480, Issuer analyzes it under Subtopic 815-40.

The forward contract meets that Subtopic’s two criteria for equity classification, as summarized in the following table.

Requirement under Subtopic 815-40	Evaluation of prepaid forward contract ¹
Indexed to the entity’s own stock (sections 8.7 – 8.8)	The contract is indexed to Issuer’s own stock. Step 1. Not applicable because the contract does not contain any exercise contingencies. Step 2. The contract’s settlement amount is fixed-for-fixed, except for standard antidilution adjustments that are permitted adjustments to the settlement amount.
Qualifies for equity classification (sections 8.10 – 8.12)	Issuer will receive shares in physical settlement of the contract.
<p>Note:</p> <p>1. This Example assumes that provisions in an ISDA agreement relating to the contract do not preclude meeting the indexation and classification requirements; see sections 8.5 and 8.8.30 as well as Questions 8.10.20 and 8.12.30.</p>	

Accounting treatment

Issuer concludes that the prepaid forward contract meets the requirements to be classified in permanent equity. On January 1, Year 1 (inception), Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
APIC	1,000	
Cash		1,000
<i>To recognize prepaid forward contract issued as equity.</i>		

Subsequent adjustments to the value of the contract are not recognized as long as the contract remains classified in permanent equity.

On January 1, Year 2 (maturity), Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Treasury shares ¹	1,000	
APIC		1,000
<i>To recognize 50 shares received in physical settlement of prepaid forward contract.</i>		
Note:		
1. This Example assumes Issuer presents treasury shares as a deduction from total equity. Other presentations may be acceptable (see Question 5.8.10).		

Net equity is not affected at maturity.



Example 11.2.20

Physically settled prepaid forward purchase contract for a variable number of shares

On January 1, Year 1 (inception), Issuer pays \$1,000 cash to enter into a freestanding forward contract to purchase a variable number of its own \$1 par common equity shares with a fair value of \$1,100 to be delivered on January 1, Year 2 (maturity).

The contract requires physical settlement. It does not include any exercise contingencies.

Evaluating classification under Topic 480

One general scope requirement of Topic 480 is that a financial instrument reflect an obligation of the issuer (see section 6.2.30). In this example, Issuer does not have an obligation because it:

- does not have a conditional or unconditional obligation to transfer assets to settle the instrument because the assets have already been transferred at inception; and
- will *receive* – rather than *issue* – its equity shares in settlement at maturity.

Therefore, the forward contract is not classified as a liability under Topic 480.

Evaluating classification under Subtopic 815-40

Because the forward contract is outside the scope of Topic 480, Issuer analyzes it under Subtopic 815-40. The forward contract meets that Subtopic's two criteria for equity classification, as summarized in the following table.

Requirement under Subtopic 815-40	Evaluation of prepaid forward contract ¹
Indexed to the entity's own stock (sections 8.7 – 8.8)	The contract is indexed to Issuer's own stock. Step 1. Not applicable because the contract does not contain any exercise contingencies. Step 2. The settlement amount changes as Issuer's share price changes. However, the only variable that could affect

Requirement under Subtopic 815-40	Evaluation of prepaid forward contract ¹
	the settlement amount (i.e. Issuer's share price) is a permitted input in determining the fair value of a fixed-for-fixed instrument.
Qualifies for equity classification (sections 8.10 – 8.12)	Issuer will receive shares in physical settlement of the contract.
Note: 1. This Example assumes that provisions in an ISDA agreement relating to the contract do not preclude meeting the indexation and classification requirements; see sections 8.5 and 8.8.30 as well as Questions 8.10.20 and 8.12.30.	

Accounting treatment

Issuer concludes that the prepaid forward contract meets the requirements to be classified in permanent equity. On January 1, Year 1 (inception), Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
APIC	1,000	
Cash		1,000
<i>To recognize prepaid forward contract issued as equity.</i>		

Subsequent adjustments to the value of the forward contract are not recognized as long as the contract remains classified in permanent equity.

On January 1, Year 3 (maturity), Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Treasury shares ¹	1,000	
APIC		1,000
<i>To recognize shares received in physical settlement of prepaid forward contract.</i>		

Note:

- This Example assumes Issuer presents treasury shares as a deduction from total equity. Other presentations may be acceptable (see Question 5.8.10).

Upon receipt of the shares at maturity, Issuer records treasury shares for \$1,000 even though it receives \$1,100 worth of its equity shares (because Issuer locked in that \$1,000 price at the inception of the equity-classified instrument). Therefore, net equity is not affected at maturity.



Example 11.2.30

Physically settled prepaid forward sale contract for a fixed number of shares

On January 1, Year 1 (inception), Issuer receives \$1,000 cash to enter into a freestanding forward contract to sell 50 of its own \$1 par common equity shares to be delivered on January 1, Year 2 (maturity).

The contract requires physical settlement. It does not include any exercise contingencies and does not provide for any adjustments to the settlement amount other than standard antidilution provisions.

Evaluating classification under Topic 480

One general scope requirement of Topic 480 is that a financial instrument reflect an obligation of the issuer (see section 6.2.30). In this example, Issuer does not have an obligation because it:

- does not have a conditional or an unconditional obligation to transfer assets to settle the instrument because it will be settled through issuing equity shares; and
- will issue a *fixed* – rather than a *variable* – number of its equity shares in settlement at maturity.

Therefore, the prepaid forward contract is not a liability under Topic 480.

Evaluating classification under Subtopic 815-40

Because the forward contract is outside the scope of Topic 480, Issuer analyzes it under Subtopic 815-40. The forward contract meets that Subtopic’s two criteria for equity classification as summarized in the following table.

Requirement under Subtopic 815-40	Evaluation of prepaid forward contract ¹
Indexed to the entity’s own stock (sections 8.7 – 8.8)	The contract is indexed to Issuer’s own stock. Step 1. Not applicable because the contract does not contain any exercise contingencies. Step 2. The contract’s settlement amount is fixed-for-fixed, except for standard antidilution adjustments that are permitted adjustments to the settlement amount.
Qualifies for equity classification (sections 8.10 – 8.12)	Issuer will issue a fixed number of shares in physical settlement of the contract. This Example assumes the additional requirements for equity classification are also met, including that Issuer has sufficient authorized and unissued shares to settle the contract.
Note: 1. This Example assumes that provisions in an ISDA agreement relating to the contract do not preclude meeting the indexation and classification requirements; see sections 8.5 and 8.8.30 as well as Questions 8.10.20 and 8.12.30.	

Accounting treatment

Issuer concludes that the prepaid forward contract meets the requirements to be classified in permanent equity. On January 1, Year 1 (inception), Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	1,000	
APIC		1,000
<i>To recognize prepaid forward contract issued as equity.</i>		

Subsequent adjustments to the value of the contract are not recognized as long as the contract remains classified in permanent equity.

On January 1, Year 2 (maturity), Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
APIC ¹	50	
Common shares – par value ¹		50
<i>To recognize shares issued in physical settlement of prepaid forward contract.</i>		
Note:		
1. \$1 par value per share × 50 shares issued.		

Net equity is not affected at maturity.



Example 11.2.40

Physically settled prepaid forward sale contract for a variable number of shares

On January 1, Year 1 (inception), Issuer receives \$1,000 cash to enter into a freestanding forward contract to sell a variable number of its own \$1 par common equity shares with a fair value of \$1,100 to be delivered on January 1, Year 2 (maturity).

The contract requires physical settlement. It does not include any exercise contingencies.

Evaluating classification under Topic 480

Issuer does not have a conditional or unconditional obligation to transfer assets in settlement of the instrument. However, Issuer concludes that it meets the criteria for certain obligations to issue a variable number of shares that are required to be classified as liabilities under Topic 480, as summarized in the following table.

Criteria (Question 6.6.10)	Evaluation of prepaid forward contract
Freestanding financial instrument	The contract is a freestanding financial instrument.
Types of instruments	The contract is a financial instrument.
Reflects an obligation of the issuer	The contract: <ul style="list-style-type: none"> — embodies an unconditional obligation; and — requires Issuer to settle that unconditional obligation by delivering a variable number of its equity shares.
Settlement	The monetary value of the contract must be settled by issuing a variable number of Issuer's equity shares.
Monetary amount based solely or predominantly on one of three specific criteria	The specific criteria are: <ul style="list-style-type: none"> — a fixed monetary amount known at inception; — variations in something other than the fair value of Issuer's equity shares; or — variations inversely related to changes in the fair value of Issuer's equity shares. <p>Issuer determines that the fixed monetary value criterion is met because it is required to transfer a variable number of its equity shares with a fair value of \$1,100 at maturity.</p>

Therefore, the contract is classified as a liability under Topic 480.

Accounting treatment

The prepaid forward contract represents an obligation to issue a variable number of common shares for a fixed monetary amount (stock-settled debt). These instruments are subject to the measurement guidance in Topic 835 and are measured subsequently at accreted value – accruing interest on the settlement amount using the rate implicit at inception (see section 6.9.50).

On January 1, Year 1 (inception), Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	1,000	
Stock-settled debt obligation		1,000
<i>To recognize prepaid forward contract issued as a liability.</i>		

On December 31, Year 1, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Interest expense	100	
Stock-settled debt obligation ¹		100
<i>To recognize interest expense on the liability.</i>		

Note:

1. Represents full accretion of the difference between the issuance and settlement amounts, because the entry is immediately before the instrument's maturity.

Issuer's common shares have a fair value of \$25 per share on January 1, Year 2 (maturity). As a result, Issuer issues 44 common shares in settlement of the prepaid forward contract ($\$1,100 \div 25$). On that date, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Stock-settled debt obligation	1,100	
Common shares – par value ¹		44
APIC ²		1,056
<i>To recognize shares issued in physical settlement of prepaid forward contract.</i>		
Notes:		
1. \$1 par value per share × 44 shares issued.		
2. Excess of proceeds from issuance of shares (\$1,100) – Par value of shares issued (\$44).		

11.3 Prepaid written put options on an entity's own shares

In a prepaid written put option, the issuer agrees to purchase its own equity shares from the counterparty at the maturity date if the share price is less than the option strike price. At inception, the issuer pays a net cash amount representing the following:

- prepayment of the option's strike price, which typically represents the fair value of the shares at inception; less
- an option premium received for writing the option.

These instruments are typically structured as European-style options – i.e. the options can be exercised only on the maturity date. At maturity, the option is settled in one of two ways depending on the issuer's share price relative to the strike price at the settlement date.

Situation	Settlement	Economic effect
Share price is greater than strike price	The put option is out-of-the-money and, as a result, is not exercised. Therefore, the counterparty returns the issuer's prepayment of the strike price. The issuer typically is permitted to elect settlement in cash or a number of issuer's shares equivalent to the settlement amount.	The issuer gets a return on its initial investment in the amount of the option premium. This is because the full amount of the strike price is returned to the issuer and the issuer keeps the option premium received at inception.

Situation	Settlement	Economic effect
Share price is less than strike price	The put option is in-the-money and, as a result, is exercised. Therefore, the counterparty delivers the specified number of the issuer's shares underlying the option to the issuer. Because the issuer prepaid the strike price at the inception of the option, no cash payment is made.	The issuer repurchases its own shares at a price below the market price at inception – i.e. at less than the market price by the amount of the option premium.

These instruments are also referred to as 'Dragons' or 'Caesars'.

Because a prepaid written put option is an equity-linked financial instrument, the decision tree in section 2.3.40 is used to identify the applicable guidance.



Example 11.3.10 Prepaid written put option

On January 1, Year 1 (inception), Issuer and Bank enter into a freestanding prepaid written put option. Under the option's terms, Bank is allowed to sell 1,000 of its own \$1 par common equity shares to Issuer for a strike price of \$100 per share on January 1, Year 2 (maturity). The fair value of Issuer's shares at contract inception is \$100 per share.

The contract requires physical settlement. It does not include any exercise contingencies and does not provide for any adjustments to the settlement amount other than standard antidilution provisions.

Issuer pays Bank \$90,000 upfront, which represents:

- \$100,000 prepayment of the option's strike price (\$100 per share × 1,000 shares); less
- \$10,000 option premium (\$10 per share × 1,000 shares).

Evaluating classification under Topic 480

One general scope requirement of Topic 480 is that a financial instrument reflect an obligation of the issuer (see section 6.2.30). Issuer does not have an obligation because it:

- does not have a conditional or unconditional duty or responsibility to transfer assets to settle the instrument because Issuer has prepaid its obligation at inception and has no remaining obligation to transfer assets or issue equity shares; and
- will *receive* – rather than *issue* – its equity shares in settlement at maturity.

Therefore, the prepaid written put option is not classified as a liability under Topic 480. This is so even though non-prepaid written put options are generally considered liabilities under Topic 480.

Evaluating classification under Subtopic 815-40

Because the prepaid written put option is outside the scope of Topic 480, Issuer analyzes it under Subtopic 815-40. The contract meets that Subtopic's two criteria for equity classification, as summarized in the following table.

Requirement under Subtopic 815-40	Evaluation of prepaid written put option ¹
Indexed to the entity's own stock (sections 8.7 – 8.8)	The contract is indexed to Issuer's own stock. Step 1. Not applicable because the contract does not contain any exercise contingencies. Step 2. The contract's settlement amount is fixed-for-fixed, except for standard antidilution adjustments that are permitted adjustments to the settlement amount.
Qualifies for equity classification (sections 8.10 – 8.12)	Issuer will receive shares in physical settlement of the contract.
<p>Note:</p> <p>1. This Example assumes that provisions in an ISDA agreement relating to the prepaid written put option do not preclude meeting the indexation and classification requirements; see sections 8.5 and 8.8.30 as well as Questions 8.10.20 and 8.12.30.</p>	

Accounting treatment

Issuer concludes that the prepaid written put option meets the requirements to be classified in permanent equity. At inception, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
APIC	90,000	
Cash		90,000
<i>To recognize prepaid written put option issued as equity.</i>		

Subsequent adjustments to the value of the contract are not recognized as long as the contract remains classified in permanent equity.

Scenario 1: \$70 fair value per common share at maturity

Issuer's common shares have a fair value per share of \$70 per share on January 1, Year 2 (maturity). Because this is less than the \$100 strike price of the prepaid written put option, the put option is in-the-money and, as a result, is exercised. Therefore, Issuer receives the 1,000 of its own equity shares underlying the option. Because Issuer prepaid the strike price at the inception of the option, no cash payment is made.

On the maturity date, Issuer receives its own shares and records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Treasury shares ¹	90,000	
APIC		90,000
<i>To recognize shares received in physical settlement of prepaid written put option.</i>		
Note:		
1. This Example assumes Issuer presents treasury shares as a deduction from total equity. Other presentations may be acceptable (see Question 5.8.10).		

The economic effect of the prepaid written put option is that Issuer repurchases its own shares for \$90,000, which is less than the \$100,000 market price at inception of the contract.

Scenario 2: \$110 fair value per common share at maturity

Issuer’s common shares have a fair value per share of \$110 per share on January 1, Year 2 (maturity). Because this is more than the \$100 strike price of the prepaid written put option, the put option is out-of-the-money and, as a result, is not exercised. Therefore, Bank returns Issuer’s prepayment of the option’s strike price.

On that date, Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash ¹	100,000	
APIC		100,000
<i>To recognize return of prepayment of written put option’s strike price when it expired unexercised.</i>		
Note:		
1. \$100 per share × 1,000 shares.		

The economic effect of the prepaid written put option is that Issuer gets a return on its initial investment in the amount of the \$10,000 option premium. This is because the full amount of the strike price is returned to Issuer and Issuer keeps the option premium received at inception.

Question 11.3.10

Can a combination of call options that is economically equivalent to a prepaid written put option be combined into one unit of account?

Background: The following combination of contracts is economically equivalent to a prepaid written put option:

- a European-style purchased call option with a strike price of \$0 per share (i.e. deep-in-the-money purchased call option) that is physically settled; and
- a European-style written call option with a strike price equal to the price of the issuer's share at the inception of the contract.

Under this two-contract structure, the amount paid (i.e. prepayment) at the inception of the contract represents:

- a premium paid on the deep-in-the-money purchased call option (i.e. the option's fair value); less
- a premium received on the written call option (i.e. the option's fair value).

Because the strike price of the purchased call option is \$0, the issuer will always exercise the purchased call option at the maturity date to repurchase the shares. The counterparty will exercise the written call option only if the share price is higher than the strike price at the maturity date. If both options are exercised, the number of shares to be received by the issuer and the number of shares to be received by the counterparty will be netted (i.e. net to zero shares) and the issuer will only receive cash equal to the strike price of the written call option.

Interpretive response: Yes. We generally believe the call options described in the background should be combined for accounting purposes based on the guidance in Topic 815 (see Question 6.3.90) when they are not legally detachable and separately exercisable. Issuing a combination of a purchased call option and a written call option at the same time with a single counterparty for the same number of underlying shares is economically equivalent to issuing a prepaid written put option. Further, the purchased call option and the written call option are entered into in contemplation of each other.



Example 11.3.20

Prepaid written put option structured as two options (purchased call option and written call option)

On January 1, Year 1 (inception), Issuer enters into the following contracts:

- a European-style purchased call option with Bank for 1,000 of its own \$1 par common equity shares for a strike price of \$0 on January 1 Year 2 (maturity); and
- a European-style written call option with Bank for 1,000 of its own \$1 par common equity shares for a strike price of \$100 on January 1 Year 2 (maturity).

The fair value of Issuer's shares at contract inception is \$100 per share. Both contracts require physical settlement. Neither contract includes any exercise contingencies or provides for any adjustments to the settlement amount other than standard antidilution provisions. Further, the contracts are not legally detachable and separately exercisable.

Issuer pays Bank \$90,000 upfront, which represents:

- the fair value of the purchased call option; less
- the fair value of the written call option.

The following table summarizes the possible settlement outcomes for the options.

Share price on January 1, Year 2 (maturity)	Settlement	Economic effect
Greater than \$100	<p>Purchased call option. Issuer will exercise it to receive 1,000 shares from Bank for \$0.</p> <p>Written call option. Bank will exercise it to receive 1,000 shares from Issuer for \$100,000.</p> <p>Net settlement. The obligations to deliver 1,000 shares offset and Issuer will receive \$100,000 from Bank in net settlement.</p>	Issuer gets a return on its initial investment of \$10,000 – i.e. the \$100,000 received at maturity less than \$90,000 net amount paid at inception.
Less than \$100	<p>Purchased call option. Issuer will exercise it to receive 1,000 shares for \$0.</p> <p>Written call option. Bank will not exercise it because it is out-of-the-money.</p>	Issuer repurchases its own shares for \$90,000, which is less than the \$100,000 market price at inception of the contract.

Evaluating the unit of account

As discussed in Question 11.3.10, the call options are combined for accounting purposes based on the guidance in Topic 815. Issuer performs a similar analysis to the one explained in Example 11.3.10 for the combined unit of account.

11.4 Accelerated share repurchase programs

An accelerated share repurchase (ASR) program is a combination of transactions that allows an entity to repurchase a targeted number of shares immediately, with the final repurchase price determined by an average market price over a fixed period of time. ASR programs are generally accounted for as follows:

- a repurchase of common shares in a treasury share transaction recorded on the acquisition date under Topic 505 (see section 5.8.60); and
- a net-settled forward sale contract under Subtopic 815-40 (see section 8.16.30).

See further discussion about ASR programs in section 5.8.60.

However, if an ASR program differs from the programs discussed in Topic 505, elements of it may be in scope of Topic 480 – either a transaction in the program or one of the program’s components.

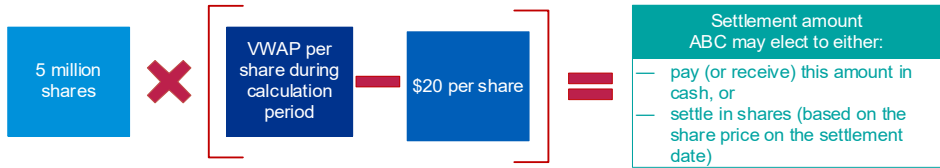
Because a net-settled forward sale contract is an equity-linked financial instrument, the decision tree in section 2.3.40 is used to identify the applicable guidance when it is a separate unit of account.

Example 11.4.10 Prepaid ASR transaction

On March 29, Year 1 (trade date), Issuer enters into an ASR agreement with Investment Bank. The ASR represents a combination of two transactions.

- **Treasury shares acquisition.** On April 3, Year 1 (settlement date of the treasury shares acquisition), Issuer will purchase 5 million shares of its \$1 par common stock from Investment Bank for \$100 million in cash. This reflects a per-share price of \$20, which is Issuer’s share price on the trade date.
- **Forward contract on Issuer’s shares.** On June 3, Year 1 (forward contract settlement date), Issuer will either receive or deliver its own \$1 par common shares depending on how the volume-weighted average share price (VWAP) between April 3, Year 1 and June 3, Year 1 (the ‘calculation period’) compares to the share price at the trade date. The forward contract allows Issuer to elect cash or net-share settlement. It does not include any exercise contingencies and does not provide for any adjustments to the settlement amount other than standard antidilution provisions.

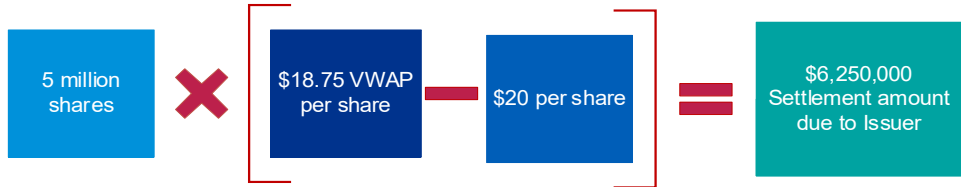
The contract price (settlement amount) under the forward contract is as follows.



The following assumptions relate to the share price of Issuer’s common stock.

Date	Share price / VWAP
March 29, Year 1 (trade date)	\$20
April 3, Year 1 (treasury shares acquisition settlement date)	20
June 3, Year 1 (forward contract settlement date)	18.50
VWAP	18.75

Based on the VWAP during the calculation period, Investment Bank owes Issuer a settlement amount for the forward contract of \$6,250,000. This is calculated as follows.



Further, assume that the treasury share repurchase and forward contract are appropriately accounted for as two separate transactions (see Question 5.8.140).

Date on which to record ASR transaction

On March 29, Year 1, Issuer is obligated to transfer \$100 million of cash to Investment Bank on April 3, Year 1, in exchange for which Issuer will receive five million shares of its own stock. This arrangement represents a financial instrument (other than an outstanding share) that embodies an obligation to repurchase Issuer's equity shares and it requires Issuer to settle the obligation by transferring assets. As a result, this represents a liability in the scope of Topic 480 (see section 6.5).

This obligation arises on the day Issuer signs the ASR agreement (i.e. the trade date, March 29, Year 1) and it extends to the settlement date (i.e. April 3, Year 1). Therefore, Issuer records a liability on the trade date with an offsetting entry recorded to APIC.

Evaluating forward contract's classification under Topic 480

Topic 480 requires three classes of financial instruments to be classified as liabilities. The forward contract does not fall into any of these classes, as summarized in the following table. Therefore, it is not classified as a liability under Topic 480.

Class of financial instrument	Evaluation of forward contract
Mandatorily redeemable financial instruments (section 6.4)	<p>The forward contract is not a liability under this class of financial instruments because the forward contract, which is not a share, does not obligate Issuer to transfer assets. Instead, the settlement outcomes are as follows.</p> <ul style="list-style-type: none"> — Share price increases: Issuer can transfer either cash or shares (i.e. not an asset). — Share price decreases: Issuer can receive either its own shares or cash.
Obligations to repurchase the issuer's equity shares by transferring assets (section 6.5)	<p>The forward contract is not a liability under this class of financial instruments because it does not obligate Issuer to transfer assets (see explanation in under 'Mandatorily redeemable financial instruments' above).</p>
Certain obligations to issue a variable number of shares (section 6.6)	<p>If Issuer's share price increases, Issuer is permitted to net-share settle its obligation under the forward contract (i.e. issue a variable number of shares). However, the forward contract is not a liability under this class of financial instruments because, at inception, the monetary value of the obligation is <i>not</i> based solely or predominantly on any of the following.</p> <p>A fixed amount known at inception. The monetary amount received or delivered at settlement of the forward contract is determined based on the difference in the VWAP over the forward contract's term and the share price at the settlement date. Since it changes as the VWAP changes, this amount is not predominantly based on a fixed monetary amount.</p> <p>Variations inversely related to fair value changes in Issuer's equity shares. The monetary amount received or delivered at settlement of the forward contract is based directly (not inversely) on Issuer's share price. That is, if</p>

Class of financial instrument	Evaluation of forward contract
	<p>Issuer's share price increases, Issuer will deliver shares or cash; conversely, Issuer will receive shares or cash if its share price decreases.</p> <p>Variations in something other than the fair value of Issuer's equity shares. The monetary amount is based on variations in the fair value of Issuer's shares, not on variations in something else.</p>

Evaluating forward contract's classification under Subtopic 815-40

To meet the requirements for equity classification of Subtopic 815-40, the forward contract (which is treated as a freestanding instrument) must be indexed to Issuer's own stock and qualify for equity classification. The forward contract meets these requirements, as summarized in the following table. See also Question 8.16.20 for common provisions that result in an ASR forward contract's failing to meet these requirements.

Requirement under Subtopic 815-40	Evaluation of forward contract ¹
Indexed to the entity's own stock (sections 8.7 – 8.8)	<p>The contract is indexed to Issuer's own stock.</p> <p>Step 1 (section 8.7). Not applicable because the forward contract does not contain any exercise contingencies.</p> <p>Step 2 (section 8.8). The forward contract's settlement amount is fixed-for-fixed, except for standard antidilution adjustments that are permitted adjustments to the settlement amount.</p>
Qualifies for equity classification (sections 8.10 – 8.12)	<p>The forward contract gives Issuer the option of either net-share settlement or cash settlement.</p> <p>This Example assumes the additional requirements for equity classification are also met, including that the ASR agreement includes a maximum number of shares that Issuer could be obligated to issue (and the number of Issuer's authorized and unissued shares exceeds that maximum number of shares).</p>
<p>Note:</p> <p>1. This Example assumes that provisions in an ISDA agreement relating to the forward sale contract do not preclude meeting the indexation and classification requirements; see sections 8.5, 8.8.30 and 8.16.30 as well as Questions 8.10.20 and 8.12.30.</p>	

Journal entries

On March 29, Year 1 (trade date), Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
APIC	100,000,000	
Liability for share repurchase		100,000,000
<i>To recognize share repurchase obligation under ASR agreement on trade date.</i>		

On April 3, Year 1 (settlement date of the treasury share acquisition), Issuer transfers cash to settle its obligation. Issuer records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Liability for share repurchase	100,000,000	
Cash		100,000,000
<i>To recognize settlement of share repurchase obligation.</i>		
Treasury shares ¹	100,000,000	
APIC		100,000,000
<i>To recognize acquisition of treasury shares.</i>		
Note:		
1. This Example assumes Issuer presents treasury shares as a deduction from total equity. Other presentations may be acceptable (see Question 5.8.10).		

Because it is classified as equity, no subsequent accounting for the forward contract is required until it is settled.

Scenario 1: Issuer elects to receive the settlement amount in cash

Settlement in cash effectively decreases the price paid per treasury share. Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	6,250,000	
Treasury shares		6,250,000
<i>To recognize cash settlement of forward contract.</i>		

Under this scenario, the cost basis of each of the five million treasury shares purchased on April 3, Year 1, is reduced to \$18.75 per share $[(\$100,000,000 - \$6,250,000) \div 5,000,000 \text{ shares}]$ – i.e. the VWAP during the calculation period.

Scenario 2: Issuer elects to receive the settlement amount in shares

Under this scenario, ABC receives 337,837 additional treasury shares (i.e. $\$6,250,000 \text{ settlement amount} \div \$18.50 \text{ share price on June 3}$). Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Treasury shares	6,250,000	
APIC		6,250,000
<i>To recognize share settlement of forward contract.</i>		

As discussed in Question 5.8.150, Issuer has two options for calculating the cost basis of the treasury shares it holds.

- **Actual cost.** Issuer's treasury shares related to this ASR would consist of 5,000,000 shares initially purchased for \$20 per share and 337,837 additional shares purchased for \$18.50 per share.
- **Average cost.** Issuer's treasury shares related to this ASR all have a cost of \$18.73 per share ($\$100 \text{ million} \div 5,337,837 \text{ total shares}$).

11.5 Convertible debt with call spread transactions

In these transactions, convertible debt is issued in conjunction with a call spread. A call spread transaction represents two separate call option transactions on the issuer's own shares:

- **purchased call option:** this option typically has the same strike price as the debt's conversion price and is for the same number of shares as the debt's conversion shares; and
- **written call option:** this option is typically at a higher strike price than the debt's conversion option.

A call spread can be either documented as two separate transactions (i.e. a purchased call option and a written call option) or structured as a single transaction referred to as a capped call option. In either case, the economics of each arrangement is the same. Some transactions may only involve the issuer issuing convertible debt and separately purchasing a call option, which is typically referred to as a bond hedge.

See further discussion about:

- convertible debt in chapter 10; and
- call spreads, including capped calls, in section 8.4.50.

These transactions commonly include overallotment (greenshoe) provisions (see section 5.3.70).

The decision tree in section 2.3.20 is used to identify the applicable guidance for debt instruments, including convertible debt. Because call options are equity-linked financial instruments, the decision tree in section 2.3.40 is used to identify the applicable guidance when they are separate units of account.



Example 11.5.10

Convertible debt with capped call option

On January 1, Year 1, Issuer issues for par \$100 million of convertible notes to a group of several Buyers in a private placement. Also on that date, Issuer pays cash of \$10 million to enter into a capped call option on its own common shares with Investment Bank.

Convertible notes terms

The notes bear interest at 3% and mature on January 1, Year 6. The initial conversion rate for the notes is 15 of Issuer's common shares per \$1,000 par value of the notes (i.e. \$66.667 initial conversion price), resulting in a total of 1.5

million shares issuable under the convertible note. On initial issuance of the notes, the market price of Issuer's common shares is \$50 per share.

On conversion, Issuer can elect to settle by delivering any combination of cash or common shares equal to the if-converted value. Any net share or net cash settlement is determined based on the VWAP over a 20-day observation period.

Buyers can exercise the conversion feature at any time on or after October 1, Year 5. However, Buyers can elect to exercise the conversion feature earlier than that date upon the occurrence of the following events:

- common share price exceeds 130% of the conversion price for at least 20 trading days during the 30 consecutive trading days at the end of the prior calendar quarter;
- recapitalization of Issuer's equity shares through a large, nonrecurring cash dividend;
- rights offering (distribution of options or warrants to purchase Issuer's equity shares below market value) or a tender offer above market value; or
- make-whole fundamental change, defined as the following events:
 - any person or group becoming the beneficial owner of more than 50% of Issuer's common shares;
 - consummation of a transaction in which Issuer's common shares are reclassified or converted into cash, securities or other property;
 - sale or lease of substantially all of Issuer's assets, or an approved plan for a liquidation or dissolution of Issuer; or
 - delisting of Issuer's common shares.

Further, the conversion rate is subject to adjustment upon the occurrence of certain events, as summarized in the following table. The appropriate adjustment is determined by Investment Bank as the calculation agent, which is expected to exercise judgment in good faith and make the determinations and calculations in a commercially reasonable manner. Further, under no circumstance is the conversion rate permitted to exceed 30 shares per each \$1,000 note.

Event	Adjustment to conversion ratio
Equity restructurings: <ul style="list-style-type: none"> — stock dividends, stock splits — recapitalization of Issuer's equity shares through a large, nonrecurring cash dividend — rights offering or a tender offer above market value. 	Adjustment to neutralize the effect of the transaction to Issuer's share price/maintain the value of the conversion option.
Make-whole fundamental change	Conversion shares increased by a number of shares specified in a table having axes for time and share price. The table was designed such that the aggregate fair value of the shares deliverable would be expected to approximate the convertible notes' fair value at the settlement date, assuming no change in relevant pricing inputs (other than share price and time) since their issuance. The table includes a cap

Event	Adjustment to conversion ratio
	(maximum) on the aggregate number of shares to be issued.

In addition to the conversion feature, the debt includes the following embedded features.

- **If an event of default occurs.** Buyers are permitted to demand immediate cash repayment of principal and accrued but unpaid interest; this represents a contingent put option. Further, the convertible notes accrue additional interest at a rate of 0.25% if they remain outstanding; this represents a contingent interest feature;
- **If a make-whole fundamental change occurs.** Buyers are permitted to demand immediate cash repayment of principal and accrued but unpaid interest; this represents a contingent put feature. In combination with the conversion feature, this results in Buyers having two options when such an event occurs: accept cash for the principal and unpaid interest on the convertible notes, or convert their notes based on the adjusted conversion rate in the make-whole fundamental change table.

Capped call option terms

The capped call option allows Issuer to purchase from Investment Bank the same number of Issuer’s common shares (i.e. a total of 1.5 million shares) at the same strike price (\$66.667 per share) as the convertible notes. However, the cap price is \$100 per share of common stock, which limits the potential upside for Issuer.

The capped call option is exercisable at its maturity of January 1, Year 6 but automatically exercises on earlier conversion of the convertible notes. Its terms allow for net cash or net-share settlement, or a combination of both, at Issuer’s option. If net-settled, the settlement amount for the capped call option is calculated as the difference between the strike price and the VWAP over a 20-day observation period, with a maximum amount of \$50 million (i.e. 1.5 million shares × (\$100 cap price – \$66.667 strike price)).

In addition to the cap price, the terms of the capped call option include provisions that adjust the settlement amount, as summarized in the following table.

Event	Adjustment to conversion ratio
Equity restructurings: <ul style="list-style-type: none"> — stock dividends, stock splits — recapitalization of Issuer’s equity shares through a large, nonrecurring cash dividend rights offering or a tender offer above market value. 	Adjustment to neutralize the effect of the transaction to Issuer’s share price/maintain the value of the conversion option.

Evaluating the unit of account

Issuer must first determine whether the convertible notes and the capped call option represent separate freestanding units of account or whether they represent a combined unit of account.

An instrument is freestanding if it is entered into either (1) separate and apart from any of the entity's other financial instruments or equity transactions; or (2) in conjunction with another transaction but legally detachable and separately exercisable. Because the convertible notes and capped call option were entered into in conjunction with each other, Issuer determines whether they are legally detachable and separately exercisable. Issuer issued the convertible notes to Buyers and entered into the capped call option with Investment Bank (who is one of the Buyers). The provisions of the capped call option give Investment Bank the right, without Issuer's consent, to transfer its rights or obligations under the capped call option to a third party. This means that even though the convertible notes and the capped call option were entered into in conjunction with one another, the capped call option is legally detachable and separately exercisable from the convertible notes.

Issuer also considers whether the instruments must be combined into a single unit of account. Issuer considers the following indicators.

- The instruments were entered into separately for substantive business purposes.
 - The convertible notes were issued to provide relatively lower cash interest cost financing to Issuer.
 - The capped call option was separately entered into to reduce the dilution impact that would occur if the convertible notes are converted and represents an economic hedge against appreciation of Issuer's common share price during the option's term.
- Although the transactions were executed with the same counterparty, they are legally detachable and separately exercisable from each other.
- The instruments do not relate to the same risk. The convertible notes contain interest rate risk, credit risk and equity risk of Issuer. However, the capped call option does not contain credit risk of Issuer.

As a result of this analysis, Issuer concludes that the convertible notes and capped call option are separate units of account.

For more guidance on determining units of account, see section 6.3 and section 8.3.

Convertible debt accounting model

Issuer does not measure the convertible debt at fair value – i.e. Issuer does not elect the fair value option (see also Question 9.3.30) and US GAAP does not otherwise require it. Therefore, the guidance for convertible instruments in chapter 10 is used to determine the appropriate accounting model.

Evaluating embedded derivative model for convertible debt

1. Evaluating whether conversion option requires bifurcation –Section 10.3.10

The first step in determining the appropriate accounting is to determine whether the conversion option must be bifurcated and accounted for as a derivative under Topic 815.

The conversion option in Issuer’s convertible debt meets the definition of a derivative because it has an underlying (Issuer’s common share price), there is no initial net investment for the conversion option itself, and a notional (number of shares) and it is net settleable (Issuer is permitted to settle a conversion with cash, shares or a combination thereof – e.g. Issuer is permitted to settle the conversion spread in shares having a value equal to the conversion spread; see Question 10.3.20.

The conversion option is not clearly and closely related to the convertible debt because changes in the fair value of a conversion feature (which allows for conversion to an equity interest) generally are not clearly and closely related to a debt host contract; see Question 10.3.40.

Therefore, Issuer considers whether the own equity scope exception from derivative accounting applies to the conversion option based on the requirements in Subtopic 815-40. To meet those requirements, the conversion option must be indexed to Issuer’s own stock and qualify for equity classification. The conversion option meets these requirements, as summarized in the table below.

Requirement under Subtopic 815-40	Evaluation of conversion option ¹
Indexed to the entity’s own stock (sections 8.7 – 8.8)	<p>The conversion option is indexed to Issuer’s own stock.</p> <p>Step 1. The conversion option is exercisable on or after October 1, Year 5. However, earlier exercise is permitted upon the occurrence of the following events, which represent exercise contingencies:</p> <ul style="list-style-type: none"> — common share price exceeds 130% of the conversion price during a specified period; — recapitalization of Issuer’s equity shares; — a merger or tender offer; or — a make-whole fundamental change. <p>None of these events is an observable market or index (other than those related to Issuer’s own stock or operations, as applicable), and therefore they do not preclude equity classification.</p> <p>Step 2. The contract’s settlement amount is fixed-for-fixed, except for the following adjustments.</p> <ul style="list-style-type: none"> — Make-whole fundamental change: This represents an adjustment based on a table that is consistent with adjustments described in section 8.8.60. — Equity restructurings: These are considered standard antidilution adjustments that are permitted adjustments to the settlement amount; — Net settlement amounts (if applicable) are based on VWAP: This is an acceptable adjustment because the

Requirement under Subtopic 815-40	Evaluation of conversion option ¹
	<p>only input is Issuer's share price, which is used in determining the fair value of a fixed-for-fixed contract; see Question 8.8.70.</p> <p>These adjustments do not preclude equity classification.</p>
Qualifies for equity classification (sections 8.10 – 8.12)	The terms of the conversion option allow share settlement at Issuer's option. Because the settlement method is at the option of Issuer, it appears the requirements of the equity classification guidance are met. However, Issuer must also analyze the conversion option against the additional requirements for equity classification; see analysis in following table.
<p>Note:</p> <p>1. This Example assumes that provisions in an ISDA agreement relating to the conversion option (convertible debt) do not preclude meeting the indexation and classification requirements; see sections 8.5 and 8.8.30 as well as Questions 8.10.20 and 8.12.30.</p>	

The following table summarizes whether the additional conditions required for equity classification are met for the conversion option.

Additional condition required for equity classification	Evaluation of conversion option ¹
Entity has sufficient authorized and unissued shares	<p>See section 8.12.20</p> <p>Issuer performs an analysis and concludes it has sufficient authorized and unissued common shares to settle the conversion option (which would include all shares due for physical settlement and the maximum number of shares due under the make-whole fundamental change), considering the maximum number of shares Issuer could be required to deliver under existing commitments (e.g. other outstanding convertible instruments, outstanding shares and warrants).² Therefore, this condition is met.</p>
Contract contains an explicit share limit	<p>See section 8.12.30</p> <p>The convertible notes have a fixed conversion rate, which represents an explicit share limit, except that the rate is subject to certain adjustments. Those adjustments were evaluated as follows.</p> <ul style="list-style-type: none"> — Make-whole fundamental change: The conversion shares are increased by a number of shares specified in a table. The table includes a cap (maximum) on the aggregate number of shares to be issued. Therefore, this adjustment continues to result in an explicit share limit. — Equity restructurings: The events resulting in these adjustments are within Issuer's control and therefore are disregarded; see Question 8.12.100. <p>Therefore, this condition is met.</p>

Additional condition required for equity classification	Evaluation of conversion option ¹
No required cash payments if the entity fails to timely file	See section 8.12.40 The conversion option does not require net-cash settlement of the convertible notes if Issuer does not make timely filings with the SEC. Therefore, this condition is met.
No cash-settled top-off or make-whole provisions	See section 8.12.50 The conversion option does not require Issuer to make a cash payment if shares delivered upon conversion are subsequently sold by Buyers and the proceeds from that sale are insufficient to provide Buyers with full return of the amount due. Therefore, this condition is met.
<p>Notes:</p> <ol style="list-style-type: none"> 1. This Example assumes that provisions in an ISDA agreement relating to the conversion option do not preclude meeting the indexation and classification requirements; see sections 8.5 and 8.8.30 as well as Questions 8.10.20 and 8.12.30. 2. This analysis is not shown in this Example. 	

In conclusion, the conversion option does not represent an embedded derivative that requires bifurcation.

2. Evaluating whether other embedded features require bifurcation – chapter 9

Issuer evaluates whether the other embedded features in the convertible notes (a debt host contract) represent embedded derivatives requiring bifurcation as follows.

- **Contingent interest upon debtor’s default (e.g. violation of a credit-risk-related covenant).** An embedded derivative is clearly and closely related to a debt host contract when the interest rate is reset in the event of the issuer’s default because that relates to Issuer’s creditworthiness (see Questions 9.3.200 and 9.3.250). Because this feature is clearly and closely related to the debt host contract, it is not separated as an embedded derivative.
- **Contingent put options.** If an event of default or a make-whole fundamental change occurs, Buyers are permitted to demand immediate cash repayment of principal and accrued but unpaid interest. These are considered clearly and closely related to the debt instrument because (see Question 9.3.220):
 - the amount paid represents an accelerated settlement of principal and accrued interest – i.e. the amount paid is not adjusted based on changes in an index; and
 - the debt was issued at par – i.e. does not involve a substantial premium or discount.

Because these features are clearly and closely related to the debt host contract, they are not separated as embedded derivatives.

Evaluating remaining models for convertible debt— see chapter 10

Because the conversion option is not bifurcated and accounted for separately as a derivative, the next step is to determine whether the instrument was issued at a substantial premium. A substantial premium exists if the amount of issuance proceeds assigned to the convertible instrument substantially exceeds the instrument’s principal amount. Because the convertible debt was issued at par, it was not issued at a substantial premium.

Because the convertible debt is not accounted for under the embedded derivative or substantial premium models, it is accounted for under the no proceeds allocated model, meaning that no portion of the issuance proceeds is ascribed to the conversion feature. The instrument is subsequently measured at amortized cost.

Evaluating capped call option classification

Capped call options are equity-linked financial instruments, so the decision tree in section 2.3.40 is used to identify the applicable guidance.

Evaluating capped call option classification under Topic 480

One general scope requirement of Topic 480 is that a financial instrument reflect an obligation of the issuer (see section 6.2.30). Issuer does not have an obligation because it:

- does not have a conditional or unconditional duty or responsibility to transfer assets or issue shares to settle the instrument because Issuer can elect net settlement; and
- will potentially *receive* – rather than issue – its equity shares upon exercise.

Therefore, the purchased call option is not classified as a liability under Topic 480.

Evaluating capped call option classification under Subtopic 815-40

The capped call option meets Subtopic 815-40’s criteria for equity classification, as summarized in the following table.

Requirement under Subtopic 815-40	Evaluation of capped call option ¹
Indexed to the entity’s own stock (sections 8.7 – 8.8)	<p>The capped call option is indexed to Issuer’s own stock.</p> <p>Step 1. The call option is exercisable at its maturity of January 1, Year 6. However, it automatically exercises on earlier conversion of the convertible notes. In other words, the exercise of the capped call options is contingently accelerated upon the conversion of the notes. The conversion option of the convertible notes is exercisable on or after October 1, Year 5, with earlier exercise permitted upon the occurrence of the following events:</p> <ul style="list-style-type: none"> — common share price exceeds 130% of the conversion price during a specified period; — recapitalization of Issuer’s equity shares; — a merger or tender offer; or — make-whole fundamental change. <p>Neither a conversion nor any of the events triggering early conversion is an observable market or index (other than</p>

Requirement under Subtopic 815-40	Evaluation of capped call option ¹
	<p>those related to Issuer’s own stock or operations, as applicable), and therefore they do not preclude equity classification.</p> <p>Step 2. The settlement amount of the capped call option is calculated as the difference between the strike price and the fair value of Issuer’s equity shares. However, adjustments to the settlement amount can be made (using commercially reasonable means) upon the occurrence of certain events.</p> <ul style="list-style-type: none"> — Cap price. The cap price has the effect of fixing the fair value of the shares subject to the capped call option based on the \$100 fixed cap price. As discussed in section 8.8.40, a stock price cap does not preclude the instrument from being considered indexed to the entity’s own shares. — Equity restructurings. These provisions that allow for adjustments to the settlement amount are considered standard antidilution provisions. Their purpose is to neutralize the impact of the event occurring. As discussed in section 8.8.50, standard valuation models for fixed-for-fixed contracts make certain implicit assumptions, including that dilutive events (such as these) will not occur. If such an implicit assumption is invalidated (e.g. because a dilutive event occurs), an adjustment to neutralize the effect of that invalidation on the settlement amount of an instrument generally does not preclude the instrument from being considered indexed to the entity’s own shares. — Settlement amounts are based on VWAP. This is an acceptable adjustment because the only input is Issuer’s share price, which is used in determining the fair value of a fixed-for-fixed contract; see Question 8.8.70. <p>These adjustments do not preclude equity classification.</p>
<p>Qualifies for equity classification (sections 8.10 – 8.12)</p>	<p>The terms of the capped call option allow net-cash or net-share settlement, or a combination of both, at Issuer’s option. Because the settlement method is at the option of Issuer, it appears the requirements of the equity classification guidance are met. However, Issuer must also analyze the call options against the additional requirements for equity classification; see analysis in the following table.</p>
<p>Note:</p> <p>1. This Example assumes that provisions in an ISDA agreement relating to the capped call option do not preclude meeting the indexation and classification requirements; see sections 8.5 and 8.8.30 as well as Questions 8.10.20 and 8.12.30.</p>	

The following table summarizes whether the additional conditions required for equity classification are met for the capped call option.

Additional condition required for equity classification	Evaluation of capped call option ¹
Entity has sufficient authorized and unissued shares	See section 8.12.20 This condition is not applicable because Issuer will receive shares upon settlement (not deliver them).
Contract contains an explicit share limit	See section 8.12.30 This condition is not applicable because Issuer will receive shares upon settlement (not deliver them).
No required cash payments if the entity fails to timely file	See section 8.12.40 There are no cash payments required by Issuer if it were to not timely file its periodic reports with the SEC.
No cash-settled top-off or make-whole provisions	See section 8.12.50 This condition is not applicable because the holder of the capped call option is the issuer of the instrument.
<p>Note:</p> <p>1. This Example assumes that provisions in an ISDA agreement relating to the capped call option do not preclude meeting the indexation and classification requirements; see sections 8.5 and 8.8.30 as well as Questions 8.10.20 and 8.12.30.</p>	

Issuer concludes that the capped call option meets the requirements of both the indexation guidance and the equity classification guidance. As a result, the instrument is classified as equity and recognized at its \$10 million fair value at purchase. It will not be remeasured unless it no longer qualifies to be classified in equity.

Economic effect of capped call option

The objective of the capped call option is to synthetically increase the strike price of the conversion feature in the convertible notes. It will also reduce the dilutive impact of the share issuance on conversion of the convertible notes. This is illustrated through the scenarios in the following table.

Scenario	Settlement	Economic effect of capped call option
<p>Notes are converted when Issuer's share price is \$80</p> <p>(i.e. share price is greater than \$66.667 strike price but less than the cap price of \$100)</p>	<p>Convertible notes: If-converted value of the convertible notes is \$120 million.¹ Issuer can elect to settle the:</p> <ul style="list-style-type: none"> — \$100 million par value with cash; and — \$20 million² conversion spread with 250,000 shares³ <p>Capped call option: Issuer can elect to net-share settle the capped call option's \$20 million intrinsic value,⁴ receiving 250,000 shares³</p> <p>Net shares issued: 0</p>	<p>In exchange for the \$10 million option premium, Issuer economically benefits from the convertible notes' low interest</p>

Scenario	Settlement	Economic effect of capped call option
<p>Notes are converted when Issuer's share price is \$120</p> <p>(i.e. share price is greater than the cap price of \$100)</p>	<p>Convertible notes: If-converted value of the convertible notes is \$180 million.⁵ Issuer can elect to settle the:</p> <ul style="list-style-type: none"> — \$100 million par value with cash; and — \$80 million⁶ conversion spread with 666,667 shares⁷ <p>Capped call option: Issuer can elect to net-share settle the capped call option's \$50 million capped intrinsic value,⁸ receiving 416,667 shares⁹</p> <p>Net shares issued: 250,000</p>	<p>rate while mitigating the share dilution that would otherwise result from conversion of the convertible notes</p>
<p>Notes:</p> <ol style="list-style-type: none"> 1. 1.5 million shares issuable on conversion × \$80 share price. 2. \$120 million if-converted value – \$100 million par value. 3. \$20 million conversion spread ÷ \$80 share price. 4. 1.5 million shares issuable on exercise of capped call option × (\$80 share price – \$66.667 strike price). 5. 1.5 million shares issuable on conversion × \$120 share price. 6. \$180 million if-converted value – \$100 million par value. 7. \$180 million conversion spread ÷ \$120 share price. 8. 1.5 million shares issuable on exercise of capped call option × (\$100 cap price – \$66.667 strike price). 9. \$50 million capped intrinsic value ÷ \$120 share price. 		

11.6 Debt automatically exchanged upon next round of equity financing and otherwise convertible

Many times, debt instruments include multiple features that require analysis to determine the appropriate accounting. Example 11.6.10 builds on concepts covered in chapters 9 and 10. The convertible debt instrument is contingently puttable upon a change in control and also is automatically exchanged for equity shares issued in a future round of financing with a settlement amount based on a fixed monetary amount. The exchange feature is a type of embedded feature often referred to as a 'conversion option' that is not a conversion option in the context of Subtopic 470-20.

See further discussion about:

- convertible debt in chapter 10; and
- embedded derivatives in chapter 9.

The decision tree in section 2.3.20 is used to identify the applicable guidance for debt instruments, including convertible debt. See further discussion about convertible debt in chapter 10 and about embedded derivatives in chapter 9.



Example 11.6.10

Debt that is automatically exchanged upon next round of equity financing and otherwise convertible

On January 1, Year 1, Issuer, a nonpublic entity, issues to Holder a convertible note for its par value of \$1 million. The note bears interest at 5% and matures on January 1, Year 3.

The note includes the following embedded features.

- **Contingent conversion option.** If the next round of equity financing of at least \$5 million does not occur by January 1, Year 2, Holder has the ability to convert the notes at any time to 100,000 of Issuer's existing Series A preferred shares resulting in an effective conversion price of \$10 per share (\$1 million proceeds ÷ 100,000 shares). The conversion option is *contingent* because the note is only convertible if there is not another round of equity financing by January 1, Year 2. The fair value of Series A preferred shares at the commitment date of the note is \$10 per share. The note requires physical settlement.
- **Contingent exchange feature.** The terms of the note provide that upon the next round of equity financing of at least \$5 million, all unpaid accrued interest will immediately be paid in cash and 100% of the outstanding principal balance of the note will automatically exchange into that series of equity financing. The number of shares will equal the quotient obtained by dividing the outstanding principal balance by the product of (1) the per-share price paid by the investors in that round of equity financing, multiplied by (2) 80% (i.e. at a 20% discount).
- **Contingent put option (upon change in control).** On a change in control, Holder can elect to put the note back to Issuer for the outstanding principal and accrued interest.

The instrument's legal form is debt and therefore it is classified as debt (see Question 2.2.20). It does not represent an obligation to issue a variable number of shares because Issuer will only be required to issue shares if it issues a new round of equity financing (i.e. Issuer is only obligated if it takes certain actions). Instead, at inception of the instrument, Holder is entitled to cash at maturity of the instrument (or upon a change of control). As a result, Issuer does not account for this instrument under Topic 480. Further, Issuer does not elect to measure the note at fair value.

Embedded derivative model

See also chapter 9 and chapter 10

The first step in determining the appropriate accounting model for the convertible note is to determine whether the conversion option (and any other embedded features) must be bifurcated and accounted for as a derivative under Topic 815.

Contingent conversion option

Section 10.3.10 summarizes guidance about when a conversion option is bifurcated.

The conversion option does not represent an embedded derivative because it does not meet the definition of a derivative. Although it has an underlying (Issuer's common share price) and notional (number of shares), it is not net settleable. The contract requires physical settlement (i.e. no contractual net settlement) and Issuer is a nonpublic entity (i.e. the shares to be delivered upon conversion are not readily convertible to cash).

Contingent exchange feature

Under this feature, Holder will receive a variable number of equity shares after an equity financing that will have a monetary value equal to \$1,250,000 (i.e. a premium of \$250,000 over the convertible note's par value). This is the outcome regardless of the issue price of those shares, as the following table illustrates.

Principal amount	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Price per share in next round of financing (assumed)	\$2.00	\$7.00	\$15.00	\$1,000.00
Holder's conversion price per share ¹	\$1.60	\$5.60	\$12.00	\$800.00
Number of shares issuable upon conversion²	625,000	178,571	83,333	1,250
Total value upon conversion ³	\$1,250,000	\$1,250,000	\$1,250,000	\$1,250,000
Premium to debt holder⁴	\$250,000	\$250,000	\$250,000	\$250,000
Notes:				
1. Price per share in next round of financing × 80% (i.e. 20% discount).				
2. Principal amount ÷ Holder's conversion price per share.				
3. Number of shares issuable upon conversion × Price per share in next round of financing.				
4. Total value upon conversion – Principal amount.				

As discussed in Question 10.2.50, this feature does not embody a conversion option, but instead is like a contingent prepayment option (i.e. a put option) that is settleable in a variable number of shares with a fixed value, even though it may be referred to as 'conversion option'. This is because the exchange feature does not vary with Issuer's share price, but instead results in Holder receiving a variable number of shares that is based on a fixed monetary amount.

As discussed in Question 9.3.220, a contingent prepayment option embedded in a debt instrument that accelerates repayment of the principal amount requires separate accounting as a derivative if the debt involves a substantial premium or discount. Under the contingent exchange feature, the premium that will be received if an exchange occurs will be 25% of Holder's initial investment, which is considered a substantial premium. Therefore, at inception, Issuer bifurcates the embedded derivative liability (i.e. the contingent put option) and initially recognizes it at fair value. Assume its fair value is \$200,000.

Substantial premium model

See also chapter 10

The next step is to determine whether the instrument was issued at a substantial premium. A substantial premium exists if the amount of issuance proceeds assigned to the convertible instrument substantially exceeds the instrument's principal amount. Because the convertible note was issued for its principal amount, it was not issued at a significant premium. Therefore, there is no separate accounting for the conversion option.

No proceeds allocated model

See also chapter 10

Since the convertible debt is not accounted for under any of Subtopic 470-20's other accounting models, it is accounted for under the no proceeds allocated model, meaning that no portion of the issuance proceeds are ascribed to the conversion feature.

Record the transaction

Issuer records the following journal entry for the issuance of the convertible note.

	<i>Debit</i>	<i>Credit</i>
Cash	1,000,000	
Note payable – Discount on note payable ¹	200,000	
Note payable		1,000,000
Embedded derivative liability ¹		200,000
<i>To recognize issuance of note.</i>		
<p>Note:</p> <p>1. Proceeds are allocated to the embedded derivative (exchange feature) for its fair value, with the remaining proceeds allocated to the note payable. Note that the embedded derivative is recorded at its fair value of \$200,000 and not its contingent payout amount of \$250,000.</p>		

The embedded derivative (exchange feature) subsequently is measured at fair value each period with changes in fair value reported in earnings (see section 9.5.20). The discount on the note payable is amortized over the term of the instrument using the effective interest method (see chapter 3).

11.7 Special-purpose acquisition companies

Special-purpose acquisition companies (SPACs) are shell or 'blank-check' companies that have no operations. They raise funds through public markets with the intention of merging with or acquiring one or more target companies with the proceeds raised from the SPAC's IPO and (if necessary) additional funding through such sources as a private investment in public equity (PIPE) or similar sources.

The sole purpose of the SPAC is to execute a merger with a target operating company, as defined in the registration statement and governing documents. SPAC management typically comprises individuals with extensive industry and mergers and acquisitions experience. If the merger is not executed within a predetermined period of time (e.g. two years from the IPO date), the initial funds received from the issuance of the IPO shares are repaid to the current shareholders and the SPAC is dissolved – unless the SPAC extends that time in accordance with its governing documents.

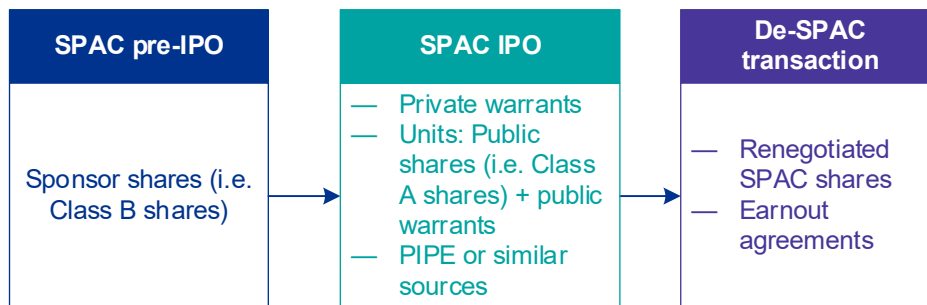
Once the SPAC’s shareholders approve the merger, the transaction closes and the target becomes a public entity (post-merger registrant). The process of consummating the merger transaction is referred to as the ‘de-SPAC’ process.

Financial instruments commonly issued during the SPAC and de-SPAC lifecycle include:

- founder’s shares (also known as sponsor’s shares);
- IPO shares;
- private warrants;
- public warrants;
- PIPE or similar sources; and
- earn-out shares.

Shares, warrants and PIPE or similar sources may also be subject to renegotiation throughout the SPAC and de-SPAC lifecycle.

Some of the instruments may include various features, including redemption features, which affect their classification and measurement as either equity, temporary equity or liability.



Question 11.7.10
Does a SPAC record a liability for deferred underwriter fees in connection with its IPO?

Background: In our experience, a common fee structure between the SPAC and the underwriter is for a total fee (e.g. 5.5%) based on the IPO proceeds, with a certain percent (e.g. 2.5%) paid at the IPO’s close and the remaining percent (i.e. the deferred fees, e.g. 3%) deferred to be paid at a later date.

- If the SPAC executes a merger (the de-SPAC transaction), the fees are due and payable to the underwriter.

- If the SPAC does not execute a merger, the deferred underwriter fees are not paid.

The SPAC records IPO proceeds as an asset with a corresponding credit to allocate those proceeds to the instrument(s) issued (e.g. temporary equity, liability). Additionally, it records the portion of the underwriter fees paid at the IPO's close as a cost of issuing the instrument(s) in the IPO.

Interpretive response: Yes. We believe it is generally appropriate to accrue the liability for the deferred portion as of the IPO date and treat it as a cost of issuing the instrument(s) in the IPO, as long as:

- the underwriter is under no obligation beyond the IPO date to perform future services in exchange for the deferred fee; and
- It is probable that a merger will be executed.

If future services are required, those deferred fees should be accounted for at the time services are performed based on the nature of the services. If future services are not required and execution of the merger is not probable, the fees should be accrued when it becomes probable.

Our view is based on the deferred underwriter fee containing the characteristics of a contingent liability, as defined in Topic 450 (contingencies), which requires a contingent liability to be accrued when it is both reasonably estimable and probable of occurring. Although usually a business combination is not deemed probable before its consummation, we believe that the merger may be deemed probable – and a liability established – for the deferred underwriter fee as of the IPO date – when:

- the sole purpose of the SPAC is to identify a target and merge with it and substantial funds already have been raised (e.g. through the IPO) for this purpose; and
- SPAC management comprises individuals with extensive experience in mergers and acquisitions.

Further, establishing a liability informs the stakeholders of the actual amount of cash available for a merger.

If the deferred underwriter fee is not paid, we believe the liability should be reduced with a corresponding reversal of the amount recorded as a cost of issuing the instruments in the IPO. This is consistent with the SEC staff's guidance on accounting for reducing a liability for 'trailing fees' – i.e. costs related to the sale of shares or units, including sales commissions and certain distribution fees that are paid over an extended period of time – which we believe is analogous in this situation.

For example, SPAC previously issued instruments in an IPO and accrued a liability for deferred underwriter fees. SPAC is no longer pursuing a target and, as a result, is in the process of liquidating its assets and returning capital to its investors. SPAC reduces the liability for deferred underwriter fees to \$0. The corresponding reversal depends on classification of the instruments issued in the IPO:

- **Equity-classified common shares.** When SPAC initially recorded a deferred underwriter fee liability, it recorded a corresponding amount in

APIC. SPAC should reverse the deferred underwriter fee liability with a corresponding amount recorded in APIC.

- **Temporary-equity classified instruments.** When SPAC initially recorded the deferred underwriter fee liability, it recorded a corresponding amount in temporary equity – i.e. in the carrying amount of the temporary-equity classified instruments. SPAC subsequently remeasured the temporary-equity classified instruments to their maximum redemption amount (see Question 7.4.10), and as a result the amount initially recorded against APIC was reclassified against retained earnings with a related reduction in income available to common shareholders in calculating EPS (see chapter 3 of KPMG Handbook, [Earnings per share](#)). SPAC should reverse the deferred underwriter fee liability and the corresponding amount in retained earnings, with a related increase in income available to common shareholders in calculating EPS.
- **Warrants that do not meet the criteria to be classified in equity (i.e. are liability-classified).** When SPAC initially recorded the deferred underwriter fee liability, it recorded a corresponding amount in expense because issuance costs are expensed when they relate to instruments that are subsequently measured at fair value (see Question 3.4.40). SPAC should reverse the deferred underwriter fee liability and the corresponding amount as a contra-expense.

This interpretive response should not be applied by analogy to other fact patterns. For example, other contingent liabilities that would vest or require payment on the completion of a business combination, such as a management bonus, should not be deemed probable until completion of the business combination.



Question 11.7.20

What are some financial instrument considerations associated with SPAC transactions?

Interpretive response: Financial instruments issued as part of a SPAC transaction give rise to various accounting issues, during both the SPAC and de-SPAC phases. The instruments frequently have features that require evaluation to determine whether they preclude equity classification under Subtopic 815-40 (see chapter 8).

The following table identifies guidance in this Handbook that is specific to certain issues that, in our experience, are more common in SPAC transactions (versus other types of transactions). This is not a comprehensive list of all possible issues related to SPAC transactions.

Question / Example	Reference
How does an entity account for a greenshoe provision?	Question 5.3.90
How does an issuer classify shares that become redeemable if the issuer completes a merger and are redeemed on a specified date if the issuer does not?	Question 7.3.125

Question / Example	Reference
Is a redeemable share's classification impacted when there are limits on the total amount of instruments that can be redeemed?	Question 7.3.126
Classification of redeemable shares with redemption subject to minimum net tangible assets limitation	Example 7.3.25
Is a redeemable instrument's subsequent measurement impacted when there are limits on the total amount of instruments that can be redeemed?	Question 7.4.75
Subsequent measurement of redeemable shares with redemption subject to minimum net tangible assets limitation	Example 7.4.55
Are equity-linked contingent consideration arrangements in the scope of Subtopic 815-40?	Question 8.2.120
Do settlement amount adjustments based on the price of a change-in-control transaction preclude equity-linked instruments from being considered indexed to the entity's own stock?	Question 8.8.75
SPAC earnout arrangement classification – tiered share issuance	Example 8.8.35
Do settlement amount adjustments based on who holds an equity-linked instrument preclude it from being considered indexed to the entity's own stock?	Question 8.8.250
Warrant's settlement amount is adjusted depending on who holds it	Example 8.8.130
Does an instrument that permits cash settlement when the holders of the underlying shares receive cash – even if no change in control or nationalization occurs – meet the equity classification requirements?	Question 8.11.15
Classification of warrants with tender offer provision by issuer with two classes of voting common shares	Example 8.11.10
Does an instrument that is puttable upon a fundamental transaction meet the requirements of the equity classification guidance?	Question 8.11.
Must an instrument's holders be able to choose the form of consideration for the consideration to be the 'same' if the holders of an instrument's underlying shares can choose?	Question 8.11.50

Other relevant guidance may also be found in the following KPMG Handbooks.

- [Business combinations](#), section 9
- [Earnings per share](#), section 6.21
- [Share-based payments](#)

11.8 Tranched preferred shares**

Preferred shares issued with a future right or obligation to issue additional preferred shares are referred to as 'tranching preferred shares' (see section 5.4.50).

The decision tree used to identify the applicable guidance for the future right or obligation depends on whether it is:

- **freestanding:** in this situation, the future right or obligation is an equity-linked financial instrument and the decision tree in section 2.3.40 is used;
- **embedded:** in this situation, the decision tree in section 2.3.30 is used to determine the accounting for the preferred share; that decision tree includes evaluating embedded features (which includes the future right or obligation) to determine whether bifurcation and separate accounting is required based on the guidance in chapter 9.



Question 11.8.10

Is a future right or obligation freestanding if it is included in the originally issued preferred shares?

Background: A freestanding financial instrument is a financial instrument that is entered into either: [\[480-10 Glossary\]](#)

- separate and apart from any of the issuer's other financial instruments or equity transactions; or
- in conjunction with another transaction but is legally detachable and separately exercisable.

Interpretive response: Because they were not issued separate and apart from each other, it depends on whether the future right or obligation is legally detachable and separately exercisable from the originally issued preferred share. If not, it is an embedded feature that is analyzed to determine whether it requires bifurcation and separate accounting.

As discussed in section 6.3.30, an important factor in evaluating whether the future right or obligation is legally detachable and separately exercisable is whether it is possible that the remaining financial instrument(s) would continue to exist unchanged when the other financial instrument is exercised.

In applying this guidance to tranching preferred shares, the issuer evaluates whether the holders can, in substance, 'detach' the originally issued preferred shares and the future right or obligation by exercising one of them while the other continues to exist unchanged. This factor is typically met because if the holder exercises the future right or obligation to purchase additional preferred shares, the originally issued preferred shares typically continue to exist unchanged (i.e. they are separately exercisable from each other).

We believe this fact supports the notion that the two instruments are legally detachable even though the holders may not be able to legally transfer the future right or obligation separately from the preferred shares. That is, the wording in the literature is that the instrument must be legally detachable,

which is not always synonymous with transferable. Therefore, we believe the future right or obligation included in the originally issued preferred shares generally represents a freestanding financial instrument. See also Question 6.3.50.

See Example 11.8.10 for an illustration of this guidance.



Question 11.8.20

Does a pay-to-play provision result in a future right or obligation being considered embedded (rather than freestanding)?

Background: Some tranching preferred shares stipulate a 'pay-to-play' provision that results in a detrimental economic impact to the holder if it does not exercise its right. For example, assume the holder is not legally required to do anything under the tranche provisions of the instrument. However, the holder's existing preferred shares are converted to common shares at an adverse ratio if the holder does not purchase additional shares from the issuer upon a milestone being attained.

Interpretive response: We are aware of diversity in practice in how to interpret whether the tranche right is freestanding or embedded when there is a pay-to-play provision.

Prevailing view

We believe the prevailing view is that a future right or obligation is still considered freestanding (as discussed in Question 11.8.10) if it is possible for the holder to convert the originally issued preferred shares into common shares before the tranche right expires or if the holder has the right to exercise the tranche right at any time prior to the milestone being attained.

Additionally, in the event that a holder is not able to convert the preferred stock into common until the tranche right is exercised or expires, we believe the prevailing view is that the two instruments generally meet the legally detachable and separately exercisable conditions because at inception the preferred stock and tranche right are capable of being separated upon the achievement of the milestone and exercise of the tranche right by the holder.

Upon the exercise of the tranche right, the preferred stock remains unchanged and the conversion feature becomes exercisable. Because the holder has discretion as to whether the tranche right is exercised when a milestone is met, its ability to elect whether to exercise the option or have the preferred converted at an adverse conversion rate does not outweigh the fact that the holder has the option to separately exercise both instruments. The ability to be separately exercised and therefore legally detachable would meet the criteria for free standing instruments.

Alternative view

Alternatively, some believe it may be acceptable to conclude that a pay-to-play provision results in the future right or obligation being considered embedded in the originally issued preferred shares if the holder is not contractually permitted

to convert the originally issued preferred shares into another instrument that does not specifically contain the same tranche right or obligation within it. That is, they believe a provision that precludes the holder from transforming its current shares into other shares without the same tranche right or obligation could support a view that the future right or obligation is not separately exercisable.

Under this view, the future right or obligation would not meet the definition of a freestanding financial instrument, and instead would represent an embedded feature in the originally issued preferred shares that is analyzed to determine whether it requires bifurcation and separate accounting. However, if the tranche right initially assessed as embedded within the originally issued preferred shares to be a freestanding instrument is exercised, effectively the exercise of the tranche right creates a separate freestanding instrument.

Conclusion

While we believe the prevailing view is that the preferred stock and tranche right are freestanding from one another even when a pay-to-play provision is present in the arrangement, we believe the alternative view that the tranche right is an embedded feature prior to its exercise may also be acceptable.

See Example 11.8.20 for an illustration of this guidance.



Example 11.8.10

Tranched preferred shares (written call option)

Issuer, a pharma company that is not an SEC registrant, issues 10 million shares of puttable convertible preferred shares (Series A preferred shares) for \$2 per share (i.e. total proceeds of \$20 million) to a single holder.

The agreement provides the holder in the Series A preferred shares with the option to purchase an additional 10 million of Series A preferred shares for \$2 per share within two years of the issuance date upon the achievement of specified development milestones that are objectively determinable related to the pharmaceutical products Issuer is developing. The future right to purchase additional Series A preferred shares is effectively a contingent warrant ('the warrant') that allows the holder to lock in the purchase price for additional shares while not committing funds until the development milestones are met (i.e. a written call option).

Additional terms stipulated in the agreement are as follows.

- Holder cannot legally transfer the warrants separately from the Series A preferred shares purchased.
- If Holder exercises the warrant, the originally issued Series A preferred shares continue to remain outstanding and Holder would receive the additional Series A preferred shares issued upon exercise of the warrant.
- Conversion option: Holder has the right to convert the Series A preferred shares into Issuer's common shares at any time on a 1:1 basis (i.e. a \$2 per share conversion price) with physical settlement required. Additionally:

- upon conversion, the warrant continues to exist unchanged (until it is exercised or expires) and the agreement does not restrict Holder from selling those common shares (other than certain restrictions under US securities laws); and
- the conversion option is out-of-the money on the issuance date.
- Redemption feature: The Series A preferred shares are redeemable by Holder upon a change in control, or due to a merger, consolidation or other deemed liquidation event (i.e. contingent put features).
- Holder in the Series A preferred shares participates in voting on an equal basis with the holders of common shares, but does not control the Board of the Issuer.

Even though it is not an SEC registrant, Issuer voluntarily applies the SEC's temporary equity guidance (see section 7.2.20).

Evaluating the unit of account

Although the preferred shares and warrant are issued in conjunction with each other, each should be accounted for as freestanding because they are legally detachable and separately exercisable. This is because Holder can exercise the warrant, while the preferred shares would continue to exist unchanged.

In addition, Holder can 'detach' the two instruments by converting the preferred shares into common shares and selling those common shares while retaining the warrant, which would continue to exist unchanged. This is the case even though Holder cannot legally transfer the warrants separately from the originally issued Series A preferred shares. See further discussion in Question 11.8.10.

Evaluating accounting for Series A preferred shares

The Series A preferred shares are equity shares, so the decision tree in section 2.3.30 is used to identify the applicable guidance.

Evaluating preferred share classification under Topic 480 (see chapter 6)

While the Series A preferred shares contain contingent redemption features, they are not mandatorily redeemable and do not represent an unconditional obligation to transfer assets. Further, the preferred shares do not contain any features that unconditionally obligate Issuer to settle them in a variable number of shares that is based on (1) a fixed monetary amount, (2) something other than the fair value of Issuer's equity shares, or (3) a monetary value that varies inversely with the fair value of Issuer's equity shares. Therefore, the Series A preferred shares are not in the scope of Topic 480.

Evaluating convertible preferred share accounting model (see chapter 10)

Convertible preferred shares are accounted for under either the embedded derivative model or the no proceeds allocated model.

Embedded derivative model

The first step in determining the appropriate accounting is to determine whether the conversion option must be bifurcated and accounted for as a derivative under Topic 815; see section 10.3.10. Assume the Issuer has separately analyzed the characteristics of the hybrid instrument and determined the host contract is more akin to equity (see Question 9.3.60). The conversion

option does not require bifurcation because it is clearly and closely related to the equity host contract; see Question 10.3.40.

Issuer evaluates whether the redemption feature (contingent put option) represents an embedded derivative requiring bifurcation. It does not meet the definition of a derivative because it is not net settleable; the nature of the host contract is more like equity; and the Series A preferred shares are not readily convertible to cash (see Question 9.3.120).

In summary, these features are not separated as embedded derivatives.

No proceeds allocated model

Because the convertible preferred stock is not accounted for under the embedded derivative model, it is accounted for under the no proceeds allocated model, meaning that no portion of the issuance proceeds allocated to the Series A preferred shares is ascribed to the conversion feature.

Evaluating temporary equity classification (see chapter 7)

The Series A preferred shares include redemption features that are outside of the Issuer's control (e.g. the contingent put upon a deemed liquidation or change in control). Therefore, as discussed in section 7.3, the Series A preferred shares are classified as temporary equity under the SEC's guidance on redeemable equity-classified instruments (which Issuer as a non-SEC registrant has elected to apply).

Evaluating warrant (call option) classification

Warrants (call option) are equity-linked financial instruments, so the decision tree in section 2.3.40 is used to identify the applicable guidance.

Evaluating warrant classification under Topic 480 (see chapter 6)

The warrant provides Holder the option to purchase additional Series A preferred shares. Those shares are contingently puttable to Issuer (e.g. upon a deemed liquidation event or change in control). A warrant for puttable shares conditionally obligates Issuer to transfer assets and therefore the warrant is classified as a liability under Topic 480 (see section 6.10.30).

Allocation of proceeds

The \$20 million in total proceeds are allocated between the Series A preferred shares and the warrant as follows (see section 7.4.20).

- The warrant is initially recognized at its fair value.
- The remaining proceeds are allocated to the Series A preferred shares.



Example 11.8.20

Tranched preferred shares with pay-to-play provisions

Assume the same facts as in Example 11.8.10 except that the agreement includes a pay-to-play provision. That provision specifies that if a milestone is achieved but Holder does not exercise the warrants, the originally issued Series A preferred shares automatically convert into common shares at a ratio of 1:0.1

shares instead of a 1:1 basis. That is, the conversion ratio is changed in a way that is detrimental to Holder.

Scenario 1: Series A preferred shares are convertible by Holder while the warrant is outstanding

Although the Series A preferred shares are automatically converted (at a detrimental ratio) if the warrant is not exercised upon milestone achievement, Holder can choose to convert Series A preferred shares at any other time (i.e. before the warrants become exercisable).

The Series A preferred shares and warrant are each considered freestanding for the same reasons as in Example 11.8.10. That is, Holder can exercise the warrant, while the preferred shares would continue to exist unchanged. In addition, Holder can 'detach' the two instruments by converting the preferred shares into common shares and selling those common shares while retaining the warrant, which would continue to exist unchanged.

As a result, Issuer accounts for the warrant and the preferred shares as discussed in Example 11.8.10.

Scenario 2: Holder can only electively convert Series A preferred shares after the warrant is no longer outstanding

In this scenario, Holder is not permitted to convert the Series A preferred shares into common shares until the earlier of the following events:

- exercise of warrant upon milestone achievement (i.e. during the warrant's two-year term); or
- expiration of the warrant (i.e. after two years).

In this scenario, we believe the warrant is still considered freestanding because Holder can exercise the warrant, while the preferred shares would continue to exist unchanged. That is, even though there is no ability for Holder to detach the instruments prior to warrant exercise, the original preferred shares continue to exist (unchanged) if Holder does exercise the warrant.

Therefore, Issuer accounts for the warrant and the preferred shares as described in Example 11.8.10.



Example 11.8.30

Tranched preferred shares with purchased put option (preferred holders control the board)

Issuer, a pharma company that is not an SEC registrant, issues 10 million shares of puttable convertible preferred shares (Series A preferred shares) for \$2 per share (i.e. total proceeds of \$20 million).

The agreement also provides the Issuer with the option to put an additional 10 million of Series A preferred shares to the Series A preferred shareholders for \$2 per share any time within two years of the issuance date. The future right to put additional Series A preferred shares is a put option (i.e. a purchased put option) that allows the Issuer to require the Series A preferred shareholders to purchase additional shares of the Issuer.

Additional terms stipulated in the agreement are as follows.

- If Issuer exercises the put option, the originally issued Series A preferred shares continue to remain outstanding and Holder would receive the additional Series A preferred shares issued upon exercise of the put option.
- Conversion option: Holder has the right to convert the Series A preferred shares into Issuer's common shares at any time on a 1:1 basis (i.e. a \$2 per share conversion price) with physical settlement required. Additionally:
 - upon conversion, the put option continues to exist unchanged (until it is exercised or expires) and the agreement does not restrict Holder from selling those common shares (other than certain restrictions under US securities laws); and
 - Redemption feature: The Series A preferred shares are redeemable by Holder upon a change in control, or due to a merger, consolidation or other deemed liquidation event (i.e. contingent put features).
- Holders of the Series A preferred shares control Issuer's board.

Although not required to, Issuer applies the SEC's temporary equity guidance (see section 7.2.20).

Evaluating the unit of account

The unit of account evaluation is consistent with Example 11.8.10, such that the purchased put option and the preferred stock are considered freestanding instruments.

Evaluating accounting for Series A preferred shares

The Series A preferred shares are equity shares, so the decision tree in section 2.3.30 is used to identify the applicable guidance.

Evaluating preferred share classification under Topic 480

The evaluation of the preferred stock under Topic 480 is consistent with Example 11.8.10, such that the preferred stock does not meet any of the criteria to be classified as a liability under Topic 480.

Evaluating convertible preferred share accounting model

The evaluation of the conversion feature within the preferred stock is consistent with Example 11.8.10, such that the conversion feature does not require separation and no proceeds are allocated to it.

Evaluating temporary equity classification (see chapter 7)

The Series A preferred shares include redemption features that are outside of Issuer's control (e.g. the contingent put upon a deemed liquidation or change in control). Therefore, as discussed in section 7.3, the Series A preferred shares are classified as temporary equity under the SEC's guidance on redeemable equity-classified instruments (which Issuer as a non-SEC registrant has elected to apply).

Evaluating purchased put option classification

The purchased put option is an equity-linked financial instrument, which allows Issuer to require the Series A preferred shareholder (Holder) to purchase additional shares of Series A preferred stock. However, as discussed in section

5.4.50, the purchased put option in-substance represents a written call option because the Holders control Issuer’s board and therefore have the ability to influence Issuer’s exercise of the put option. Therefore, the additional tranche right represents an option of Holder and if exercised would require Issuer to issue additional shares of Series A preferred stock to Holder.

The tranche right provides Holder the option to purchase additional Series A preferred shares, which are contingently puttable back to Issuer (e.g. upon a deemed liquidation event or change in control). A written call option for puttable shares conditionally obligates Issuer to transfer assets and therefore is classified as a liability under Topic 480 (see section 6.10.30).

Allocation of proceeds

The \$20 million in total proceeds is allocated between the Series A preferred shares and the tranche right as follows (see section 7.4.20).

- The written call option is initially recognized at its fair value.
- The remaining proceeds are allocated to the Series A preferred shares.

11.9 Excise tax on share repurchases * *

The Inflation Reduction Act of 2022 (IRA) was signed into law in August 2022. Among other things, it imposes a 1% excise tax on net share repurchases made by certain publicly traded corporations during a tax year. The tax applies to repurchases of common and preferred shares, net of issuances (including exercises of options or vesting of restricted shares) during the tax year.

In [IRS Notice 2023-2](#), the IRS provides initial guidance regarding the excise tax, including the companies to which it applies and how the tax is determined.

The Q&As that follow reflect issues encountered in practice since the IRA was signed into law. They explain how we believe entities should account for the excise tax under US GAAP; other alternatives may be acceptable in some situations. The following table indicates where to find additional guidance on the application of the excise tax.

Accounting consideration	KPMG publication
Retirement plans and equity-based compensation arrangements (practical considerations)	KPMG report, IRA stock buyback
Repurchases of share-based payment awards	KPMG Handbook, Share-based payment
Cash flow presentation	KPMG Handbook, Statement of cash flows



Question 11.9.10

Is the excise tax a direct and incremental cost of a share repurchase transaction?

Interpretive response: Yes. The excise tax is determined on a non-income-based measure and is therefore not accounted for as an income tax under Topic 740. In the absence of explicit guidance for taxes that are not subject to Topic 740, we believe entities should generally account for the excise tax as a direct and incremental cost of repurchasing shares, similar to treatment of other transactional taxes such as sales taxes or value-added taxes.

The accounting for a direct and incremental cost of a repurchase transaction depends on the balance sheet classification of the share that was repurchased; see Question 11.9.40 (permanent equity), Question 11.9.50 (temporary equity) and Question 11.9.60 (liability).



Question 11.9.20

When is the excise tax recognized?

Interpretive response: The excise tax (as a direct cost – see Question 11.9.10) is recognized as an obligation when shares are repurchased. We believe the recognized amount should be subsequently adjusted for any reductions to the excise tax if there are subsequent shares issued (including exercises of options or vesting of restricted shares) during the same tax year. An entity does not recognize an asset for net share issuances at a reporting date because that future benefit can only be realized if future repurchases equal or exceed total issuances in the same tax year. [IRS Notice 2023-2 2.03]




Question 11.9.30

How is an adjustment to the excise tax obligation recognized when multiple classes of common or preferred shares are repurchased during a tax year?

Interpretive response: When an entity repurchases multiple classes of common shares or preferred shares during a tax year, it records the related excise tax obligation as a cost of those repurchases (see Question 11.9.20) and that cost affects pretax income or equity based on how the shares are classified (see Questions 11.9.40, 11.9.50, and 11.9.60). When an adjustment to the total excise tax obligation is needed due to share issuances (see Question 11.9.20) and multiple classes have been repurchased, we believe an entity should select a reasonable policy for allocating the adjustment to the shares repurchased.


We believe the following methods are acceptable; there may be other acceptable approaches. The selection of a method represents an accounting policy, which is to be applied consistently and disclosed in the financial statements.

Method 1	Allocate the adjustments pro rata based on the proportion of excise tax recognized in pretax income and equity, if applicable.
Method 2	Allocate the adjustments first to the first repurchase of the tax year, next to the second repurchase, and so on.

 **Question 11.9.40**
How is the excise tax accounted for when the repurchased shares are classified in permanent equity?

Interpretive response: It depends on whether the shares are common or preferred shares, as summarized in the following table.

Type of share	Accounting treatment
Common shares	When an issuer repurchases its own permanent equity-classified common shares, the shares are referred to as ‘treasury shares’ and are accounted for under Subtopic 505-30. The cost of treasury shares – including excise taxes as a direct and incremental cost of their acquisition – is recorded as a reduction of shareholder’s equity. In our experience, treasury shares are typically presented as a separate caption in equity unless the repurchased shares are immediately retired. See also Questions 5.8.10 and 5.8.20.
Preferred shares	As discussed in Question 5.8.05, the treasury shares guidance in Subtopic 505-30 applies only to transactions involving common shares. Instead of applying that guidance, an issuer accounts for a repurchase of its own permanent equity-classified preferred shares by recording any difference between the amount paid for the repurchase and the preferred shares’ carrying amount in retained earnings as a deemed dividend (or contribution); see Question 5.4.35. The excise tax – as a cost of the repurchase transaction – is included in the amount paid for the repurchase when determining that difference and, therefore, affects deemed dividends (contributions). This is the same treatment as for preferred shares classified in temporary equity (see Question 11.9.50).

 **Example 11.9.10**
Repurchase of common shares classified in permanent equity (treasury shares)

On January 1, Year 1, Issuer issues 100,000 common shares with a par value of \$1 for \$10 per share. Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash	1,000,000	
Common shares – par value ¹		100,000
APIC ²		900,000
<i>To recognize issuance of common shares.</i>		
Notes:		
1. \$1 par value per share × 100,000 shares issued		
2. Excess of proceeds from issuance of shares (\$1,000,000) – par value of shares issued (\$100,000)		

Issuer does not subsequently remeasure the shares.

Repurchases during Year 2

On December 31, Year 2, Issuer repurchases 20,000 of its common shares for \$15 per share. The shares are held as treasury shares (i.e. the shares are not retired). Issuer records the transaction through the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Treasury shares	303,000	
Cash		300,000
Excise tax liability ¹		3,000
<i>To recognize repurchase of common shares and corresponding excise tax liability.</i>		
Note:		
1. \$300,000 repurchase price × 1% excise tax		



Question 11.9.50

How is the excise tax accounted for when the repurchased shares are temporary equity-classified preferred or common shares?

Interpretive response: If preferred or common shares are temporary equity-classified (see chapter 7), the entity accounts for their repurchase by recording any difference between the amount paid for the repurchase and the shares' carrying amount in retained earnings as a deemed dividend (or contribution). The excise tax – as a direct cost of the repurchase – is included in the amount paid for the repurchase when determining that difference. Therefore, recognition of the excise tax obligation affects deemed dividends.

See also section 7.4.70 and Question 5.4.35.



Example 11.9.20

Repurchase of preferred shares classified in temporary equity

On January 1, Year 1, Issuer (an SEC registrant) issues preferred shares for \$50 million of proceeds. The preferred shares are redeemable at fair value for cash at any date at the holders' option. No features require bifurcation and there are no other instruments issued in conjunction with the preferred shares that would require an allocation of the initial proceeds.

Because the preferred shares are redeemable at any date at the holders' option, they are classified as temporary equity. Further, they will be currently redeemable at each reporting date and, as a result, Issuer will subsequently measure them by adjusting their carrying amount to equal the maximum redemption value at each reporting date (including amounts representing dividends not currently declared or paid, but which will be payable under the redemption features or for which payment is not solely in Issuer's control). See section 7.4.40 for subsequent remeasurement guidance.

Issuer records the following journal entry on January 1, Year 1.

	<i>Debit</i>	<i>Credit</i>
Cash	50,000,000	
Temporary equity (preferred shares)		50,000,000
<i>To recognize issuance of preferred shares.</i>		

On December 31, Year 1, the fair value of the preferred shares is \$55 million. Issuer has retained earnings and there are no specific legal requirements for recording adjustments. Issuer records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Dividends– Retained earnings	5,000,000	
Temporary equity (preferred shares) ¹		5,000,000
<i>To recognize subsequent measurement of the preferred shares.</i>		

Note:

- \$55 million maximum redemption amount at reporting date – \$50 million carrying amount

Redemptions during Year 2

On December 31, Year 2, the holders exercise their right to redeem the preferred shares at current fair value of \$60 million for cash. Issuer has no issuances of shares during Year 2. Issuer has retained earnings and there are no specific legal requirements for recording the redemption. Issuer records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Dividends– Retained earnings	5,000,000	
Temporary equity (preferred shares) ¹		5,000,000
<i>To recognize subsequent measurement of the preferred shares immediately before redemption.</i>		
Temporary equity (preferred shares)	60,000,000	
Dividends– Retained earnings ²	600,000	
Cash		60,000,000
Excise tax liability ²		600,000
<i>To recognize redemption of preferred shares and related excise tax liability.</i>		
Notes:		
1. \$60 million maximum redemption amount – \$55 million carrying amount		
2. \$60 million repurchase price × 1% excise tax		

As the second and third journal entries above illustrate, the following items are not recognized in net income:

- increases in the carrying amount of temporary equity-classified instruments resulting from their subsequent measurement; and
- the difference between their repurchase price and carrying amount.

Instead, these items are treated in the same manner as dividends on nonredeemable shares (i.e. deemed dividends) and are effected by charges against retained earnings. See chapter 3 of KPMG Handbook, [Earnings per share](#).



Question 11.9.60

How is the excise tax accounted for when the repurchased shares are liability-classified?

Interpretive response: An extinguishment gain or loss is recognized for any difference between:

- the reacquisition price of extinguished liability-classified shares (i.e. debt under Topic 480, see chapter 6); and
- the shares' net carrying amount.

The excise tax – as a direct cost of the repurchase – is included in the reacquisition price when determining that difference. Therefore, recognition of the excise tax obligation affects earnings.



Example 11.9.30

Repurchase of mandatorily redeemable shares classified as a liability

On January 1, Year 1, Issuer issues preferred shares (which are subject to the excise tax) for issuance proceeds of \$15 million. Issuer must redeem the shares for \$20 million cash on December 31, Year 3; therefore, the preferred shares are mandatorily redeemable and are liability-classified.

	<i>Debit</i>	<i>Credit</i>
Cash	15,000,000	
Mandatorily redeemable preferred shares liability		15,000,000
<i>To recognize issuance of mandatorily redeemable preferred shares.</i>		

Between January 1, Year 1 and December 31, Year 3, the carrying amount is accreted to the redemption amount of \$20 million using the effective interest method.

Redemptions during Year 3

On December 31, Year 3, Issuer redeems the preferred shares for cash. Issuer has no issuances of shares during Year 3.

Issuer records the following journal entry to record the redemption of the preferred shares on December 31, Year 3.

	<i>Debit</i>	<i>Credit</i>
Mandatorily redeemable preferred shares liability	20,000,000	
Loss on extinguishment	200,000	
Cash		20,000,000
Excise tax liability ¹		200,000
<i>To recognize repurchase of redemption of mandatorily redeemable preferred shares and related excise tax obligation.</i>		
Note:		
1. \$20 million repurchase price x 1% excise tax		

Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. New Questions and Examples added in this edition are identified throughout the Handbook with **, items that have been significantly updated or revised are identified with #, and items moved are identified with ^^.

3. Debt

- 3.6.60 Classification of specific types of debt arrangements
 - Redeemable instruments subject to remarketing agreements #
 - Questions
- 3.2.10 How are trust preferred securities reported in the financial statements of a sponsor to a limited purpose trust that it does not consolidate? **
- 3.6.220 How are VRDOs classified on an issuer's balance sheet? **
- 3.6.230 How does an issuer account for the repurchase of VRDOs? **
- 3.7.95 Is a product financing arrangement a derivative if the sponsor agrees to purchase inventory at a fixed price (plus carrying and financing costs)? **

4. TDRs, debt modifications and extinguishments

- Questions
- 4.2.20 When is a debt instrument or contract outside the scope of Subtopic 470-60? #
- 4.4.21 Is an exchange of convertible debt for convertible preferred shares treated as an extinguishment? ^^
- 4.4.40 What factors are relevant when a conversion option or other feature in the original debt instrument is separately recognized as a derivative? #
- 4.5.20 How does the debtor recognize and present the gain or loss on extinguishment? #
- 4.5.30 When a debt extinguishment gain or loss is recognized in the income statement, can it be presented as interest expense? #
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- 4.5.50 How does a debtor apply extinguishment accounting when convertible debt is modified or exchanged? #
- 4.10.15 Does a debtor account for a third party's agreement to pay its debt as an extinguishment of that debt? **

4.10.16 Does an entity derecognize a liability if it has insurance to cover the loss? **

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4.10.11 Extinguishment through prepayment of note payable – loss on extinguishment ^^

4.10.12 Partial extinguishment through reacquisition of bonds in the market – loss on extinguishment ^^

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5. Equity

5.4.50 Tranched preferred shares #

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Example

5.4.15 Allocation of proceeds when preferred shares are issued with warrants **

6. Distinguishing liabilities from equity

Questions

6.4.50 Does an issuer consider term extension options and similar features when determining whether a share is mandatorily redeemable? #

6.6.45 What does an issuer evaluate to determine the appropriate classification of a Simple Agreement for Future Equity? **

7. SEC guidance on redeemable equity-classified instruments

Questions

7.2.60 Are freestanding derivative instruments that are equity-classified in the scope of the temporary equity guidance? #

7.2.70 Are hybrid instruments with embedded derivatives indexed to, and potentially settled in, an entity's own shares in the scope of the temporary equity guidance? #

- 7.2.80 Is an equity-classified component of a convertible debt instrument in the scope of the temporary equity guidance? #
- 7.2.90 Are equity-classified preferred shares convertible to common shares in the scope of the temporary equity guidance? #
- 7.2.91 Does an entity consider Eliminated Additional Conditions #1, #6, and #7 of Subtopic 815-40 when evaluating temporary equity classification? #^^
- 7.2.92 Can Eliminated Additional Condition #1 be avoided if the offering is registered at inception? ^^
- 7.2.93 How are uneconomic settlement alternatives for the issuer considered in analyzing Eliminated Additional Condition #1? #^^
- 7.2.94 What are some settlement terms that are permissible under Eliminated Additional Condition #1? ^^
- 7.2.95 Does an instrument that requires an entity to pay consideration if it is unable to register the shares fail Eliminated Additional Condition #1? ^^
- 7.2.96 What are the SEC staff's views related to Eliminated Additional Condition #1? ^^
- 7.2.97 Can an instrument meet Eliminated Additional Condition #1 if it does not specify how the contract would be settled when the entity cannot deliver registered shares? ^^
- 7.2.98 Can an equity-linked financial instrument meet Eliminated Additional Condition #1 if the entity is only required to use its 'best efforts' to register the shares that will be delivered? ^^
- 7.2.99 Does the subsequent registration of shares underlying an equity-linked financial instrument issued in a private placement cause an instrument to fail Eliminated Additional Condition #1? ^^
- 7.3.215 How are independent directors considered when appointment is mutually determined by board members who are common and preferred shareholders? **
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- 7.2.10 Uneconomic settlement alternatives in an equity-linked financial instrument #^^

8. Contracts in an entity's own equity

Chapter was previously numbered as chapter 8A but has been redesignated as chapter 8.

Questions

8.8.185 Would a 'Most Favored Nations' clause impact classification of an equity-linked or hybrid financial instrument? **

8.8.190 How does an issuer consider a settlement feature of an equity-linked financial instrument that permits delivery of unregistered shares? **

8.12.150 Does the existence of a 'buy-in' provision cause an instrument to fail the requirements of the equity classification guidance? #

Example

8.8.100 Evaluating a discount to deliver unregistered shares under Step 2 of the indexation guidance in Subtopic 815-40 **

9. Hybrid instruments with embedded features

Question

9.3.245 Is an embedded feature that provides a cash payment to the holder if the issuer pays dividends on its common stock considered clearly and closely related to a convertible debt instrument? **

10. Convertible instruments

Chapter was previously numbered as chapter 10A but has been redesignated as chapter 10.

10.8.10 Identifying an induced conversion

Future developments #

11. Comprehensive examples

11.8 Tranched preferred shares **

11.9 Excise tax on share repurchases **

12. Effective dates and transition

Removed from this edition

Moved guidance

The following table summarizes Questions and Examples that were created from previous content. See above for moved items that were significantly updated (#).

Question/Example	Old location	New location
Is an exchange of convertible debt for convertible preferred shares treated as an extinguishment?	Question 4.5.60	Question 4.4.21
Extinguishment through prepayment of note payable – loss on extinguishment	Example 4.5.30	Example 4.10.11
Partial extinguishment through reacquisition of bonds in the market – loss on extinguishment	Example 4.5.40	Example 4.10.12
Accounting for a premium to prepay a portion of the principal balance on a term loan – loss on extinguishment	Example 4.5.50	Example 4.10.13
Does an entity consider Eliminated Additional Conditions #1, #6, and #7 of Subtopic 815-40 when evaluating temporary equity classification?	Question 7.2.95	Question 7.2.91
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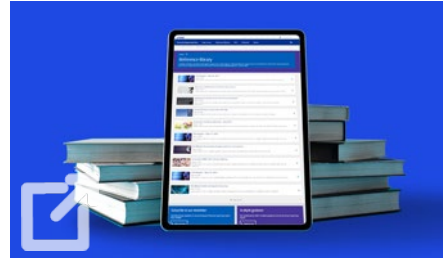
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