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FASB Issues Accounting Standards Update for Convertible Instruments

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On August 5, 2020, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2020-06 designed to reduce the complexity and improve comparability of financial reporting associated with accounting for convertible instruments and contracts in an entity's own equity.¹ This Client Alert focuses on the updates with respect to the convertible instruments.

Summary of the key changes in the ASU include:

1. Convertible debt will no longer be bifurcated into OID debt and equity for most convertibles, thus improving the GAAP interest expense treatment;
2. Precludes the use of treasury stock method for convertibles with flexible settlement with net share settlement intent;
3. Removes the following features required for equity contracts to be exempt from derivative accounting: (a) to consider whether a contract would be settled in registered shares, (b) to consider whether collateral is required to be posted, and (c) to assess shareholder rights;
4. Enhances information transparency by making targeted improvements to disclosure for convertible instruments and earnings-per share guidance; and
5. Clarifies that an average market price for a given reporting period (and not the quarter-end stock price) should be used to calculate any in-the-money share dilution.

The following table summarizes the accounting treatment before and after the ASU based on the different settlement methods for convertible debt instruments.



| | Physical Settlement | Net Share Settlement (Instrument C) | Flexible Settlement (Instrument X) | Flexible Settlement with Net Settlement Intent |
|-----------------------|--|--|---|--|
| Description | <ul style="list-style-type: none"> Always settle conversions in stock | <ul style="list-style-type: none"> Settle conversions with (1) cash for par plus (2) shares / cash for the value in excess of par at issuer's option | <ul style="list-style-type: none"> Settle conversions with any combination of cash and stock, at issuer's option | <ul style="list-style-type: none"> Flexible settlement per indenture "Intent" and "ability" rep that issuer would net share settle |
| Old Accounting | <ul style="list-style-type: none"> Single convertible debt liability on balance sheet Interest expense reflects cash coupon If-Converted Method (worse of "coupon" and "all underlying shares") for diluted EPS | <ul style="list-style-type: none"> Bifurcate into OID debt and equity Interest expense reflects cash coupon + OID accretion (i.e., approximates straight debt rate) In-the-money shares only for dilution | <ul style="list-style-type: none"> Bifurcate into OID debt and equity Interest expense reflects cash coupon + OID accretion (i.e., approximates straight debt rate) Bifurcated If-Converted Method (worse of "coupon + OID accretion" and "all underlying shares") | <ul style="list-style-type: none"> Bifurcate into OID debt and equity Interest expense reflects cash coupon + OID accretion (i.e., approximates straight debt rate) In-the-money shares only for dilution |

| | | | | |
|------------------------------|---|---|---|---|
| <p>New Accounting</p> | <ul style="list-style-type: none"> • No change | <ul style="list-style-type: none"> • Single convertible debt liability on balance sheet • Interest expense reflects cash coupon • In-the-money shares only for dilution | <ul style="list-style-type: none"> • Single convertible debt liability on balance sheet • Interest expense reflects cash coupon • If-Converted Method (worse of "coupon" and "all underlying shares") for diluted EPS | <ul style="list-style-type: none"> • Single convertible debt liability on balance sheet • Interest expense reflects cash coupon • If-Converted Method (worse of "coupon" and "all underlying shares") for diluted EPS (no Treasury stock treatment) |
|------------------------------|---|---|---|---|

The ASU allows entities to adopt the guidance through either a modified retrospective method (i.e., applying changes on an ongoing basis) or fully retrospective method (i.e., applying changes retrospectively).

Changes will be effective for "Securities and Exchange (SEC) filers" (excluding entities eligible to be smaller reporting companies defined by the SEC) for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. For all other entities, the standard will take effect for fiscal years beginning after December 15, 2023, including the interim periods within those fiscal years. In addition, early adoption is permitted for fiscal years beginning after December 15, 2020, including interim periods.

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¹ Financial Accounting Standards Board (FASB), Accounting Standards Update (ASU) No. 2020-06, *Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40)*, available [here](#).

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