This publication has been prepared for general informational purposes, and does not constitute professional advice on facts and circumstances specific to any person or entity. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication. The information contained in this publication was not intended or written to be used, and cannot be used, for purposes of avoiding penalties or sanctions imposed by any government or other regulatory body. PricewaterhouseCoopers LLP, its members, employees, and agents shall not be responsible for any loss sustained by any person or entity that relies on the information contained in this publication. Certain aspects of this publication may be superseded as new guidance or interpretations emerge. Financial statement preparers and other users of this publication are therefore cautioned to stay abreast of and carefully evaluate subsequent authoritative and interpretative guidance.

The FASB Accounting Standards Codification® material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, and is reproduced with permission.
PwC guide library

Other titles in the PwC accounting and financial reporting guide series:

- Bankruptcies and liquidations
- Business combinations and noncontrolling interests, global edition
- Consolidation and equity method of accounting
- Derivative instruments and hedging activities
- Fair value measurements, global edition
- Financial statement presentation
- Foreign currency
- IFRS and US GAAP: similarities and differences
- Income taxes
- Leases
- Loans and investments
- Property, plant, equipment and other assets
- Reinsurance—short duration contracts
- Revenue from contracts with customers, global edition
- Stock-based compensation
- Transfers and servicing of financial assets
- Utilities and power companies
This guide, Financing transactions represents the efforts and ideas of many individuals within PwC. The following PwC people contributed to the contents or served as technical reviewers of this publication:

John Bishop
Shannon Detling
Donald Doran
John Horan
Nora Joyce
Anna Kajirian
Lucy Lillycrop
Jonathan Rhine
Suzanne Stephani
Valerie Wieman
Preface

PwC is pleased to offer our Financing transactions guide. This guide was fully updated in July 2017. Since then, certain sections have been updated to reflect new guidance or interpretations. See Appendix D, Summary of significant changes, for more information.

The accounting guidance for the issuance, modification, conversion, and repurchase of debt and equity securities has developed over many years into a complex set of rules. This guide provides a summary of the guidance relevant to the accounting for debt and equity instruments and it serves as a roadmap to the applicable accounting literature to help you evaluate the accounting requirements for a particular transaction. Specifically, this guide compiles the accounting guidance a reporting entity should consider when:

- Issuing debt securities, such as:
  - Determining whether embedded features such as put and call options should be accounted for separately
  - Accounting for debt issuance costs, premiums and discounts

- Issuing preferred stock, such as:
  - Determining whether the security should be classified as debt, mezzanine equity, or permanent equity
  - Accounting for embedded conversion options, including evaluating the conversion option to determine whether it should be separately accounted for or contains a beneficial conversion feature (BCF)

- Issuing convertible debt, such as:
  - Determining the appropriate convertible debt accounting model (separation of the conversion option, cash conversion model, BCF, or debt)

- Accounting for hybrid debt and equity instruments, such as debt issued with warrants

- Modifying or extinguishing debt securities, including inducing an investor to convert a convertible debt security

- Modifying or extinguishing preferred stock and other equity securities

- Determining the accounting for guarantees or joint and several liability arrangements

- Accounting for advances to shareholders, dividends, stock splits and treasury stock

Each chapter discusses the relevant accounting literature and includes specific questions and examples to illustrate its application.
See PwC’s *Financial statement presentation* guide for information on financial statement presentation and disclosure of the instruments and transactions discussed in this guide. See PwC’s *Income taxes* guide for income tax accounting considerations related to debt and equity-linked financial instruments.

*References to US GAAP*

Definitions, full paragraphs, and excerpts from the FASB’s *Accounting Standards Codification* are clearly designated, either within quotes in the regular text or enclosed within a shaded box. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC’s original content.

*References to other chapters and sections in this guide*

When relevant, the discussion includes general and specific references to other chapters of the guide that provide additional information. References to another chapter or particular section within a chapter are indicated by the abbreviation “FG” followed by the specific section number (e.g., FG 2.3.2 refers to section 2.3.2 in chapter 2 of this guide).

*References to other PwC guidance*

This guide focuses on the accounting and financial reporting considerations for debt and equity instruments. It supplements information provided by the authoritative accounting literature and other PwC guidance. This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific chapter or section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Business combinations and noncontrolling interests, global edition (BCG)*
- *Consolidation and equity method of accounting guide (CG)*
- *Derivative instruments and hedging activities (DH)*
- *Fair value measurements, global edition (FV)*
- *Financial statement presentation (FSP)*
- *Income taxes (TX)*
- *Stock-based compensation (SC)*
- *Transfers and servicing of financial assets (TS)*

In addition, PwC’s *Accounting and reporting manual* (the ARM) provides information about various accounting matters in US GAAP.

PwC guides may be obtained through CFOdirect (www.cfodirect.com), PwC’s comprehensive online resource for financial executives, a subscription to Inform (www.pwcinform.com), PwC’s online accounting and financial reporting reference tool, or by contacting a PwC representative.
**Guidance date**

This guide was fully updated in July 2017 and considered guidance as of July 31, 2017. Since then, certain sections have been updated to clarify guidance or interpretations. See Appendix D, *Summary of significant changes*, for more information. Additional updates may be made to keep pace with significant developments. Users should ensure they are using the most recent edition available on CFOdirect (www.cfordirect.com) or Inform (www.pwcinform.com).

**Other information**

The appendices to this guide include guidance on professional literature, a listing of technical references and abbreviations, definitions of key terms, and a summary of significant changes from the previous edition.

* * * * *

This guide has been prepared to support you as you consider the accounting for financing transactions. It should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

We hope you find the information and insights in this guide useful.

Paul Kepple
US Chief Accountant
Chapter 1: Debt instruments
1.1 Chapter overview

This chapter discusses the accounting considerations for various types of debt instruments including the following topics.

- Term debt
- Lines of credit and revolving-debt arrangements
- Debt accounted for at fair value based on the guidance in ASC 825, Financial Instruments
- Amortization of deferred debt issuance costs, debt discount and premium
- Put options, call options, and other embedded components in debt instruments

See FG 3 for information on the accounting for debt modifications and extinguishments, and FG 6 for information on the accounting for convertible debt instruments. See FSP 12 for information on financial statement presentation and disclosure of debt instruments, including balance sheet classification.

1.2 Term debt

Term debt has a specified term and coupon. The coupon may be fixed, or based on a variable interest rate. Upon issuance, the issuer recognizes a liability equal to the proceeds (e.g., cash) received, less any allocation of proceeds to other instruments issued with the debt or features within the debt instrument itself. The proceeds generally approximate the present value of interest and principal payments of the debt. Debt should be recognized on the date the proceeds are received (settlement date) rather than on the trade date.

1.2.1 Debt discount and premium

When the proceeds received are not the same as the amount due at maturity, a debt instrument has been issued at a discount or premium.

Definitions from ASC Master Glossary

Discount: The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity.

Premium: The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity.

A debt discount may reflect fees paid by a reporting entity to a lender as part of a debt issuance or the issuance of debt at a below market coupon. When a reporting entity issues debt at a discount, it receives less proceeds than it will repay; thus, the reporting entity is paying a higher effective interest rate than the coupon specified in the debt agreement (i.e., it is paying the coupon and the original issue discount). Conceptually, a debt discount is a reduction of the carrying amount of a debt liability.
A debt discount can also be created by the following:

- The separation of an embedded derivative (e.g., put or call option) from a debt instrument. See FG 1.6 for information on embedded components in debt instruments.
- The separation of a beneficial conversion feature or cash conversion option in a convertible debt instrument. See FG 6.7 for information on beneficial conversion features and FG 6.6 for information on convertible instruments within the scope of the cash conversion guidance.
- The allocation of proceeds to warrants or equity securities issued in connection with a debt instrument. See FG 8.3.1 for information on debt issued with warrants.
- The adjustment to the carrying amount of a debt instrument as a result of a fair value hedging relationship. See PwC’s Derivatives and hedging guide for information on fair value hedges.

A debt premium typically reflects the issuance of debt at an above market coupon. A debt premium can also be created through an adjustment to the carrying amount of a debt instrument as a result of a fair value hedging relationship or through the separation of an embedded derivative that is an asset (e.g., a purchased option).

As discussed in ASC 835-30-45-1A, a debt discount or premium should be recorded as an adjustment to the carrying amount of the related liability.

1.2.2 Debt issuance costs

Issuance costs are specific incremental costs, other than those paid to the lender, which are incurred by a borrower and directly attributable to issuing a debt instrument. Issuance costs include the following.

- Document preparation costs
- Commissions, fees and expenses of investment bankers, underwriters, or others
- Original issue taxes
- Registration and listing fees
- Accounting and legal fees
- Other external, incremental expenses paid to advisors that clearly pertain to the financing

Costs that do not qualify as issuance costs include bonuses paid to employees (even if attributed to the employees’ involvement in the financing), employee performance stock options with long-term debt issuance milestones, and premiums for Director’s and Officers’ insurance policies (even if mandated by the underwriters).

Like debt premiums and discounts, debt issuance costs should be reported as an adjustment to the carrying amount of the related liability as discussed in ASC 835-30-45-1A.
Excerpt from ASC 835-30-45-1A
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.

See FG 1.2.3 for information on amortization of debt issuance costs.

Question 1-1 addresses the accounting treatment of a non-refundable commitment fee paid in connection with a bridge financing. Question 1-2 asks about fees paid in connection with a loan syndication.

**Question 1-1**
A reporting entity pays a non-refundable commitment fee in connection with an underwriter’s agreement to provide bridge financing in the event the reporting entity’s debt offering is delayed or cannot be executed.

Should the commitment fee be included as a debt issuance cost of the debt offering?

**PwC response**
No. ASC 340, Deferred Costs and Other Assets, provides guidance on the accounting for costs related to a bridge financing.

The commitment fee should be deferred and amortized over the commitment period. Any unamortized amount remaining upon the execution of the debt offering should be written off as the commitment has expired unused. Even if the reporting entity pays fees to the same underwriter in connection with the debt offering, ASC 340-10-S99-2 clarifies that the commitment fee and the underwriting fees should be distinguished for accounting purposes. We believe this guidance should also be applied by non-public companies.

**Question 1-2**
A reporting entity engages an investment bank to structure a loan syndication on a best efforts basis. Although the debt is not expected to be issued for several months, the bank is entitled to fees during the intervening period, based on milestones reached.

Presuming the fees incurred qualify as debt issuance costs, should the reporting entity defer these fees prior to the debt issuance?

**PwC response**
We believe the guidance in ASC 340-10-S99-1 should be applied by analogy. If the reporting entity concludes that the likelihood of the syndicated loan being placed is probable, the fees should be accounted for as a deferred asset. If, on the other hand, the likelihood of the loan syndication being placed is considered remote, it may be more appropriate to expense the fees as they are incurred.
If the loan syndication’s prospects fall somewhere between probable and remote, judgment should be applied to determine which treatment is more appropriate. Some factors to consider in determining the appropriate accounting treatment include whether payment milestones have been and are expected to be achieved and the reporting entity’s history with respect to previous debt issuances.

1.2.2.1 Amortization of debt issuance costs related to shelf registrations

To account for debt issuance costs related to a shelf registration, we believe an issuer should apply the guidance in ASC 340-10-S99 by analogy. That guidance provides the following:

- The costs should be capitalized as a prepaid expense
- When equity securities are taken off the shelf and sold, a portion of the costs attributable to the securities sold should be charged against paid in capital
- Any subsequent costs incurred to keep the filing “alive” should be charged to expense as incurred
- If the filing is withdrawn, the related capitalized costs should be charged to expense

We believe a reporting entity should capitalize costs associated with a debt shelf registration statement as a prepaid expense and allocate the costs to the debt instruments as they are offered under that shelf. Upon issuance of a debt instrument, the reporting entity should follow the guidance in ASC 470-10-35-2 for amortizing debt issuance costs. See FG 1.2.3 for further information.

Any prepaid costs that remain at the expiration of the shelf should be expensed. It may also be appropriate to expense some or all of the deferred debt issuance costs related to an aborted or withdrawn debt offering. We believe the loss contingency model in ASC 450 should be applied to determine whether the debt issuance costs are impaired (and should be expensed). Debt issuance costs should generally be considered impaired when either of the following occurs.

- It becomes probable that the offering will not result in the receipt of proceeds from the issuance of securities
- It becomes probable that the previously deferred debt issuance costs will not benefit the future securities offering

Under a combined equity and debt shelf registration, all costs should be capitalized as prepaid expenses and allocated to the equity and debt portions of the registration on a reasonable basis. Each respective portion would then be accounted for under the guidance above.

1.2.3 Amortization of debt issuance costs and debt discounts and premiums

ASC 835-30-35-2 provides guidance on the amortization of a debt discount or premium.

ASC 835-30-35-2

With respect to a note for which the imputation of interest is required, the difference between the present value and the face amount shall be treated as discount or premium and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the interest method.
Although ASC 835-30-35-2 requires the use of the interest method for the amortization of debt discount and premium, ASC 835-30-35-4 indicates that other methods of amortization, including the straight-line method, may be used if the results obtained are not materially different from those that would result from use of the interest method. These differences should be analyzed each period for materiality.

With regard to the length of the amortization period, it is not clear whether ASC 835-30-35-2 is referring to the contractual life of an instrument or some shorter period. Although it is commonly understood to mean the contractual life, depending on a debt instrument’s terms and features, it may be appropriate to amortize any discount or premium over a shorter period.

We believe a shorter amortization period, such as the period from the issuance date to the date a put is first exercisable, is appropriate when a lender can demand repayment in circumstances outside of a reporting entity’s control. Using a shorter amortization period ensures that there will be no extinguishment gain or loss in the event a lender exercises its put option prior to the contractual maturity of the debt. However, amortization over the contractual life of a debt instrument is also permitted.

In most cases, debt issuance costs are amortized over the same period as debt discount or premium. This approach is supported by guidance in ASC 470, Debt, CON 6, and other accounting literature. When a debt instrument is puttable by a lender at a price less than the par value, it may be appropriate to use a different amortization period for debt issuance costs than the debt discount and premium. See FG 1.2.3.1 for further information. When there is more than one amortization period that is acceptable, a reporting entity should elect a method, apply it consistently, and disclose it.

If a debt instrument is accounted for at fair value, the issuance costs should be immediately expensed. Further, debt discount or premium should not be recorded. To the extent the allocated proceeds received differ from the fair value of the debt instrument, the difference should be recorded in the income statement. See FG 1.5 for information on accounting for debt at fair value.

### 1.2.3.1 Amortization period for debt puttable at accreted value

In general, a discount or premium should be amortized using the interest method over the same period used to amortize debt issuance costs. However, when debt is puttable at accreted value, it may be more appropriate to amortize a discount or premium over the contractual life of the debt because the reporting entity will “retain” the unamortized portion of the discount or premium if the lender puts the debt prior to maturity. The same is not true for debt issuance costs, since these amounts are paid to third parties and are “lost” when the debt is redeemed at any price.

When a debt instrument is puttable at accreted value, we believe the discount or premium should be amortized over the contractual life of the debt such that the carrying amount of the debt is equal to the put price on the date the put is first exercisable. The discount or premium should continue to be amortized such that the carrying amount of the debt is equal to the put price on each subsequent put date as well. Because the carrying amount equals the price at which the debt can be put, there will be no gain or loss on extinguishment if the lender exercises its put option prior to maturity.

Debt issuance costs can either be amortized over the period from the issuance date to the date the put is first exercisable, or over the contractual life along with the debt discount or premium. A reporting entity should elect one of these amortization methods and apply it consistently. When the same period is used to amortize debt issuance costs and debt discount or premium (e.g., the contractual life), it
results in one constant effective rate of interest for the debt instrument, consistent with the interest method. Although issuance costs will remain on the balance sheet after the date the lender can exercise its put option and demand repayment, the same is true any time a reporting entity amortizes issuance costs over the contractual life when the instrument is puttable at an earlier date.

1.2.3.2 **Amortization period for callable debt**

Term debt that a reporting entity can call prior to its maturity date is similar to short-term debt that can be extended. Increasing rate debt is contractually short term with an embedded term-extending option that allows a reporting entity to make it long term; callable debt is contractually long term with an embedded call option that allows a reporting entity to make it short term. Therefore, we believe a reporting entity may elect to amortize debt issuance costs, discounts and premiums related to callable debt over either the contractual life of the debt instrument (consistent with term debt) or the estimated life of the debt instrument (by analogy to the guidance for increasing rate debt in ASC 470-10-35-2). A reporting entity should elect one of these methods and apply it consistently.

See FG 1.4.1 for information on the accounting for increasing rate debt.

When the exercisability of a call option is subject to a contingency, the reporting entity should consider the effect of the contingency on the likelihood the reporting entity can exercise its call option. In circumstances where the contingency is remote, the estimated life of the debt instrument and its contractual maturity should be the same.

If a reporting entity elects the estimated life of the debt instrument as the amortization period, the life used should reflect the best estimate considering the reporting entity’s plans, ability and intent to service the debt as described in ASC 470-10-35-2, as well as economic factors affecting the desirability of calling the debt. There may be circumstances in which the economic factors affecting the desirability to exercise the call option indicate that the best estimate of the debt instrument’s life is its contractual life.

We believe that an accounting policy election should be made as to whether estimates will be updated for a specific debt instrument, and that policy should be applied consistently across similar instruments. A reporting entity may decide that the estimated life is established at the issuance date and will not be updated.

1.2.3.3 **Effect of covenant violations on amortization period**

Many debt agreements contain covenants that the reporting entity must adhere to throughout the life of the agreement. Covenants are negotiated between a reporting entity and its lenders and may vary from agreement to agreement. Financial ratio covenants, which require the reporting entity to maintain various financial ratios, are included in nearly every debt agreement. A breach of a covenant triggers an event of default which may allow the lender to demand repayment (i.e., it becomes puttable).

When a covenant violation causes long-term debt to become puttable, the debt and related debt discount, premium, or issuance costs should be reclassified as current liabilities; however, we do not believe debt issuance costs, discounts, or premiums should be automatically amortized in full upon the reclassification of a long-term liability to a current liability.
ASC 470-10-45-7 indicates that the classification of the debt (and related contra accounts) does not have to be the same as the time frame used to amortize debt issuance costs, discount, and premium. A reporting entity should evaluate its specific facts and circumstances, including the following points, to determine whether it should amortize its debt issuance costs, discounts, or premiums in full.

- The nature and existence of active negotiations between the lender and the reporting entity to secure a waiver, or restructure the debt
- The financial condition of the reporting entity, and the likelihood that the lender will demand repayment rather than grant a waiver
- Its history of obtaining prior waivers, if any, from the lenders
- Execution of a written forbearance agreement and whether, during the forbearance period, the parties have agreed to negotiate to restructure the debt

If the preponderance of the evidence at the financial statement issuance date leads a reporting entity to conclude that there is a reasonable likelihood that it will be able to successfully negotiate a waiver with the lender, then amortization of debt issuance costs, discounts, and premiums should continue as before the violation, with adequate disclosure of the circumstances.

If a lender waives a covenant violation for no consideration (either explicit or implicit), no accounting is required under ASC 470-50-40 because there is no change in cash flows. A payment (of cash or other instruments) made to a lender to effect a waiver of a covenant violation is considered a modification of the terms of the debt instrument. When such a payment is made, the reporting entity should analyze the modification using the debt modification guidance discussed in FG 3.4.

Question 1-3 asks whether a covenant violation or debt modification has an effect on a reporting entity’s amortization of debt issuance costs, discounts, or premiums.

**Question 1-3**

A reporting entity violates a covenant in its puttable debt instrument. The reporting entity restructures its debt agreement and obtains a debt covenant waiver. As a result of the waiver, the debt is classified as noncurrent in its period end financial statements. As part of the restructuring, the date the put option is first exercisable is accelerated; however, the contractual term remains the same as the original debt instrument.

Does the covenant violation or debt modification have an effect on the reporting entity’s amortization of debt issuance costs, discounts, or premiums?

**PwC response**

Maybe. The reporting entity should first apply the guidance in ASC 470-50-40-10 to determine whether the changes to the instrument should be accounted for as a modification or extinguishment. See FG 3.4 for information on accounting for a modification of a term loan or debt security. If the debt instrument is modified, the reporting entity should continue to account for the debt issuance costs, discounts or premiums based on its accounting policy election as of the original issue date.

If the reporting entity has elected an amortization period from the issuance date to the date the put is first exercisable, then, as of the modification date, any unamortized debt issuance costs, discounts, or premiums...
premiums should be amortized to the new put date. If the reporting entity has elected an amortization period over the contractual life of the debt instrument, it should continue this policy.

If the modification is accounted for as an extinguishment, then any unamortized debt issuance costs, discounts, or premiums should be expensed as part of the extinguishment gain or loss.

If the reporting entity had not obtained a waiver as of the financial statement issuance date, and the preponderance of the evidence lead to a conclusion that it would not be able to negotiate a waiver, any debt issuance costs, discounts, or premiums would have been expensed as of the date that the debt became puttable (i.e., the covenant violation date), because the debt was, and would continue to be, demand debt notwithstanding any restructuring.

1.2.4 Delayed drawn debt

A reporting entity may enter into an agreement with a lender that allows the reporting entity to delay the funding of its debt, provided it is drawn within a specified time period (i.e., the reporting entity gets to choose the date that the debt funds within a specified time frame). This differs from a line of credit or revolving-debt agreement because once the debt is funded, it cannot be repaid and then borrowed again. Many agreements do not require that the reporting entity draw the full commitment amount at once; instead, a reporting entity can borrow a portion of the total debt commitment at different points in time.

When a reporting entity enters into a delayed draw debt agreement, it pays a commitment fee to the lender in exchange for access to capital over the contractual term. That is, the fees are paid whether or not the funds are ever drawn down. As such, we believe these costs meet the definition of an asset and should be recorded as such on the balance sheet and amortized on a straight-line basis over the contractual term of the arrangement (i.e., the access period); not the period over which the future debt draw will be outstanding.

Once the debt is drawn, the reporting entity should record the debt on its balance sheet, derecognize the commitment fee asset, and record a discount on the debt equal to the unamortized commitment fee. This discount should be amortized over the term of the debt. If a reporting entity borrows a portion of the debt, only a proportionate amount of the commitment fee asset should be recognized as debt discount.

1.3 Lines of credit and revolving-debt arrangements

A line of credit is an extension of credit to a borrower that can be accessed or “drawn down” at any time at the reporting entity’s discretion. Borrowings under a line of credit may be used, repaid, and reborrowed in different amounts and at different intervals. A reporting entity pays the lender a commitment fee in exchange for the lender’s commitment to lend to the reporting entity under the line of credit or revolving-debt arrangement for the term of the arrangement.

Costs associated with entering into a revolving line of credit or revolving-debt arrangement are costs incurred in exchange for access to capital. That is, the fees are paid regardless of whether the funds are ever drawn down. As such, we believe these costs meet the definition of an asset and should be recorded as such on the balance sheet (as opposed to the contra liability presentation used for debt issuance costs) and amortized on a straight-line basis over the contractual term of the arrangement (i.e., the access period).
1.4 **Other types of debt**

There are many other types of debt instruments. In the following sections we discuss the accounting considerations for some of the more common forms of structured debt instruments.

1.4.1 **Increasing rate debt**

ASC 470-10-35-1 and ASC 470-10-35-2 provide a description of and guidance on increasing rate debt.

**ASC 470-10-35-1**

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.

**ASC 470-10-35-2**

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.

The amortization period for debt issuance costs, discounts, and premiums associated with increasing rate debt should be the estimated life of the instrument.

As discussed in ASC 470-10-45-8, if increasing rate debt is repaid at par prior to its estimated maturity, the reversal of any excess interest accrued should be recognized as an adjustment of interest expense and not a part of the gain or loss on extinguishment.

ASC 815-15-25-44 provides guidance on whether a term-extending option should be separated and accounted for as a derivative. See DH 4.4.3 for information on term-extending options.

1.4.2 **Accounting for special assessments and tax increment financing entities**

A reporting entity that intends to develop real estate it owns or leases may form a tax increment financing entity (TIFE) to finance the construction of road, water, and other utility infrastructure for a specific project. The TIFE issues debt that is repaid through future user fees or tax assessments. ASC 970-470, *Real Estate* provides guidance on the accounting for a TIFE.

**ASC 970-470-25-1**

If the special assessment or the assessment to be levied by the tax increment financing entity on each individual property owner is a fixed or determinable amount for a fixed or determinable period, there is a presumption that an obligation shall be recognized by the property owner. Further, with respect to tax increment financing entities, factors such as the following indicate that an entity may be contingently liable for tax increment financing entity debt, and recognition of an obligation shall be evaluated under Topic 450:
Debt instruments

a. The entity must satisfy any shortfall in annual debt service obligations.

b. There is a pledge of entity assets.

c. The entity provides a letter of credit in support of some or all of the tax increment financing entity debt or provides other credit enhancements.

**ASC 970-470-25-2**

If the entity is constructing facilities for its own use or operation, the presence of any of the factors in the preceding paragraph creates a presumption that the tax increment financing entity debt must be recognized as an obligation of the entity.

A reporting entity should also determine whether a TIFE is a variable interest entity and whether it qualifies for a scope exception under ASC 810-10-15-17. See PwC's *Consolidation and equity method of accounting guide* for additional information on consolidation of variable interest entities.

### 1.4.3 Debt payable in common stock

Debt that requires the issuing reporting entity to make fixed payments of principal or interest in equity shares should be classified as a liability under the guidance in ASC 480 because it is an obligation to issue a variable number of shares based on a fixed dollar amount. See FG 5.5 for information on the application of ASC 480.

### 1.4.4 Multi-modal public debt

Debt issued with a “multi-modal” option provides a reporting entity with a contractual right to call the debt to change the type of interest paid. A common example of multi-modal debt is a bond that provides a reporting entity with the ability to change the interest paid from an auction-based interest rate to a stated rate; the stated rate may be based on a variable interest rate or a fixed interest rate. To change the type of interest paid a reporting entity will typically perform the following steps.

- Issue a “Notice of Interest Rate Conversion” to inform investors of the interest rate conversion (i.e., exercise of the reporting entity’s call option)
- Investors legally surrender the bonds to a tender agent
- Simultaneously, new bonds bearing the new interest rate are issued (or sold) to investors; the investors may include new investors as well as investors that held the called bonds
- The proceeds received from the new bonds are used to pay former investors a pre-determined amount specified in the bond indenture (e.g., par value). If the proceeds from the new issue are insufficient, or if the bond remarketing fails, the reporting entity funds the shortfall

Because, in most cases, an interest rate conversion involves a tender of the old bonds and marketing of new bonds, it is similar to a traditional bond refunding. When existing investors have their debt paid off, the issuer should account for the refunding as a debt extinguishment. When existing investors continue to hold the new bonds, the issuer is not subject to the modification guidance in ASC 470-50-40-10 because the exchange of the old bonds for new bonds is considered an exercise of a provision in the original debt agreement. The effective interest rate of the bonds is adjusted prospectively. See FG 3.4 for information on the accounting for an exchange of a term loan or debt security.
1.5 Accounting for debt at fair value

A reporting entity may elect to measure certain of its debt instruments at fair value, on an instrument-by-instrument basis, under the guidance in ASC 825. Electing to carry an instrument at fair value is commonly referred to as the fair value option. A reporting entity can only elect the fair value option on the date the debt instrument is initially recognized. Once made, the election is irrevocable unless a remeasurement event occurs.

ASC 825-10-15-5(f) provides guidance on the application of the fair value option to certain convertible debt instruments.

Excerpt from ASC 825-10-15-5

No entity may elect the fair value option for any of the following financial assets and financial liabilities:

f. Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders’ equity (including temporary equity) (for example, a convertible debt instrument within the scope of the Cash Conversion Subsections of Subtopic 470-20 or a convertible debt security with a noncontingent beneficial conversion feature).

Therefore, convertible debt instruments that are bifurcated into a debt and an equity component based on the guidance in ASC 470-20, such as debt with a cash conversion feature or beneficial conversion feature are not eligible for the fair value option under ASC 825 based on this guidance. The fair value option may be elected for all other convertible debt instruments, although reporting entities do not frequently elect to do so.

FV 5 discusses the principal reporting and presentation implications for items for which the fair value option is elected. With respect to debt, these implications include the following:

- The initial carrying amount of the debt is its fair value, determined in accordance with ASC 820, Fair Value Measurement, which may differ from the proceeds received upon issuance
- Issuance costs associated with the debt may not be deferred
- A reporting entity should make an accounting policy election when reporting interest expense attributable to a debt instrument carried at fair value. See FSP 20.5.1.2 for information on the presentation of interest expense (and other changes in fair value) for debt instruments carried at fair value.

See FV 6 for information on valuation considerations relevant to debt.

1.6 Embedded components within debt instruments

Many debt instruments include embedded components. A borrower should evaluate these embedded components to determine whether they are embedded derivatives within the scope of ASC 815 that should be separately carried at fair value.
ASC 815-15-25-1 provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative.

**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 this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

The most common features embedded in a debt instrument are put and call options. A put option allows a lender to demand repayment, and a call option allows a borrower to repay debt before its maturity date.

### 1.6.1 Embedded put and call options

Provided a host debt instrument is not accounted for at fair value with changes in fair value recorded in net income, the first step in assessing whether an embedded put or call option should be separately accounted for as a derivative is to determine whether the embedded option would be accounted for as a derivative under the guidance in ASC 815 if it were a freestanding instrument. To do this, a reporting entity should assess whether the embedded put or call option (1) meets the definition of a derivative or (2) qualifies for a scope exception to derivative accounting in ASC 815. Most put and call options embedded in a debt instrument do meet the definition of a derivative and do not qualify for a scope exception to derivative accounting in ASC 815. These put and call options should be evaluated to determine whether they are clearly and closely related to their host debt instrument.

See DH 2 for a discussion of the definition of a derivative and DH 3 for a discussion of scope exceptions to ASC 815.

#### 1.6.1.1 Analyzing whether an embedded put or call option is clearly and closely related to its debt host

Generally, a put or call option is considered clearly and closely related to its debt host unless it is leveraged (i.e., it creates more interest rate and/or credit risk than is inherent in the host instrument). For example, debt issued at par value that is puttable at two times the par value upon the occurrence of a specified event may have an embedded component that is not clearly and closely related to its debt host instrument.

The following figure illustrates the analysis to determine whether a put or call option is clearly and closely related to its debt host instrument. If the put or call option is not considered clearly and closely related...
related to its host debt instrument based on this analysis, it should be separately accounted for as a derivative under the guidance in ASC 815. This figure reflects the guidance in ASU 2016-06, *Contingent Put and Call Options in Debt Instruments*, which is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. All other entities have an additional year to apply the guidance, but early adoption is permitted.

**Figure 1-1**
Determining whether an embedded put or call option is clearly and closely related to its host debt instrument

---

**Determine whether the put or call option accelerates repayment of principal of the debt**

The reporting entity should first determine whether exercise of the put or call option accelerates the repayment of principal of the debt. ASC 815-15-25-41 provides guidance on put and call options that do not accelerate the repayment of the debt.
Debt instruments

ASC 815-15-25-41

Call (put) options that do not accelerate the repayment of principal on a debt instrument but instead require a cash settlement that is equal to the price of the option at the date of exercise would not be considered to be clearly and closely related to the debt instrument in which it is embedded.

If exercise of a put or call option accelerates the repayment of the debt, further analysis is required to determine whether the put or call option is clearly and closely related to its debt host.

Determine the nature of the settlement amount paid upon exercise of put or call option

The reporting entity should determine if the amount paid upon exercise of a put or call option is based on changes in an index rather than simply being the repayment of principal at par or at a fixed premium or discount. For example, a put option that entitles the holder to receive an amount determined by the change in the S&P 500 index (i.e., par value of the debt multiplied by the change in the S&P 500 index over the period the debt is outstanding) is based on changes in an equity index. On the other hand, debt callable at a fixed price of 101% is not based on changes in an index. Debt callable at a price of 108% at the end of year 1, 106% at the end of year 2, and 104% at the end of year 3 is also not based on changes in an index because the premium changes simply due to the passage of time.

If the amount paid upon exercise of a put or call option is based on changes in an index, then the reporting entity should determine whether the index is an interest rate index or credit index (specifically, the issuer’s credit). If the index is not an interest rate or credit index, the put or call option is not clearly and closely related to the debt host instrument and should be separately accounted for as a derivative under the guidance in ASC 815.

If the amount paid upon exercise of the put or call option is (1) not based on changes in an index, or (2) based on changes in an interest rate or related to the issuer’s credit, further analysis is required to determine whether the put or call option is clearly and closely related.

Question 1-4 addresses put options which allow a lender or reporting entity to receive the fair value of the debt upon exercise.

Question 1-4

Is an embedded put or call option that allows the lender or reporting entity to receive the fair value of the debt upon exercise considered clearly and closely related to its host?

PwC response

Maybe. There are circumstances when a fair value put or call option may not be considered clearly and closely related to its debt host. However, the option generally would not have a material value because its strike price is equal to the underlying’s fair value. The purpose of the option is to provide liquidity to the option holder.

Determine whether the debt instrument involves a substantial discount or premium

Practice generally considers a discount or premium equal to or greater than 10% of the par value of the host debt instrument to be substantial. Similarly, a spread between the debt’s issuance price and the
price at which the put or call option can be exercised that is equal to or greater than 10% is also generally considered substantial. However, a 10% discount or premium is not a bright-line; all relevant facts and circumstances should be considered to determine whether the discount or premium is substantial. 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.

**Determine whether the put or call option is contingently exercisable**

The reporting entity should then determine whether the put or call option is contingently exercisable. A debt instrument that an issuer can call upon a commodity price level reaching a specified price, bonds puttable if interest rates reach a specified level, and bonds puttable upon a change in control are examples of instruments with put and call options that are contingently exercisable.

1.6.1.2  **Analysis of embedded interest rate derivatives**

The guidance in ASC 815-15-25-26 should be applied if the only underlying of a put or call option embedded in a debt instrument is interest rates. If there is another underlying, for example, credit, this analysis is not required.

**ASC 815-15-25-26**

For purposes of applying the provisions of paragraph 815-15-25-1, an embedded derivative in which the only underlying is an interest rate or interest rate index (such as an interest rate cap or an interest rate collar) that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract that is considered a debt instrument is considered to be clearly and closely related to the host contract unless either of the following conditions exists:

a. The hybrid instrument can contractually be settled in such a way that the investor (the holder or the creditor) would not recover substantially all of its initial recorded investment (that is, the embedded derivative contains a provision that permits any possibility whatsoever that the investor’s [the holder’s or the creditor’s] undiscounted net cash inflows over the life of the instrument would not recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms).

b. The embedded derivative meets both of the following conditions:

1. There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor’s initial rate of return on the host contract (that is, the embedded derivative contains a provision that could under any possibility whatsoever at least double the investor’s initial rate of return on the host contract).

2. For any of the possible interest rate scenarios under which the investor’s initial rate of return on the host contract would be doubled (as discussed in (b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under the relevant future interest rate scenario) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer’s credit quality at inception.
Although it could be argued that the decision to exercise a put or call option embedded in a debt instrument is based on interest rates and credit, “plain vanilla” and “non-contingent” calls are considered to be solely indexed to interest rates as contemplated in ASC 815-15-25-26.

ASC 815-15-25-29 clarifies that in the case of a put option that permits, but does not require, the lender to settle the debt instrument in a manner that causes it not to recover substantially all of its initial recorded investment, the guidance in paragraph (a) above is not applicable.

ASC 815-15-25-37 and ASC 815-15-25-38 clarify that in the case of a call option that permits, but does not require, the reporting entity to accelerate the repayment of the debt, the guidance in paragraph (b) above is not applicable.

**Application of the test to determine whether the lender recovers substantially all of its investment**

We believe “substantially all” means approximately 90% of the investment. Therefore, if the exercise of a call option embedded in a debt instrument could result in the lender receiving less than 90% of its initial recorded investment, it likely creates an embedded interest rate derivative that should be accounted for separately. This analysis should be performed on an undiscounted basis and consider all possible events without regard to probability.

**Application of the test to determine whether the lender can double its initial rate of return and double the market rate of return**

This test is commonly referred to as the double-double test. We believe the initial rate of return that should be used in the double-double test is that of the host debt instrument without the embedded put option, not the combined hybrid instrument (debt instrument with the embedded put option). The initial rate of return on the host debt instrument may differ from the stated initial rate of return on the hybrid instrument, as the yield on the hybrid may be affected by the embedded put option. The analysis should be performed without regard to the probability of the event occurring.

When considering transactions with multiple elements, such as debt issued with warrants, the double-double test should be performed after proceeds have been allocated to the individual transactions as discussed in FG 8.3. However, the terms of the combined transaction should be considered when performing the test. For example, if upon the exercise of a put option embedded in a debt instrument issued with warrants, the lender will receive par value for the combination of the debt and warrants, it is less likely to meet the double-double test than if the lender would receive par value for the debt and the warrants remain outstanding.

For convertible debt within the scope of the cash conversion guidance in ASC 470-20, the double-double test should be performed before the bond is bifurcated as described in FG 6.6.1. Therefore, when evaluating whether an embedded put or call option should be accounted for separately, the discount created by separating the conversion option should not be considered.

**1.6.1.3 Application examples**

Example 1-1 illustrates the application of the guidance for determining whether an embedded put and call option should be separated from a debt instrument and accounted for as a derivative to debt puttable upon a change in interest rates. Example 1-2, Example 1-3 and Example 1-4 illustrate this analysis to debt puttable upon a change of control.
EXAMPLE 1-1
Debt puttable upon a change in interest rates

FG Corp issues a fixed-rate debt instrument with a term of five years, at par value. The debt contains a put option that allows the lender to put the debt when there is an increase in the 6-month LIBOR rate of 150 basis points or more, and receive 105% of the debt’s par value.

Is the embedded put option clearly and closely related to the debt host?

Analysis

FG Corp performs the analysis in Figure 1-1 as illustrated below.

---

After considering the guidance in ASC 815-15-25(b), FG Corp would conclude that the debt has an embedded interest rate derivative that should be accounted for separately because it is possible for the investor to earn double the then-current market rate for the host debt instrument. For example, if 6-month LIBOR increases to 151 basis points the day after the debt is issued and the investor puts the debt to the issuer for 105% of par, that could result in the issuer earning more (on an annualized basis) than the then-current market rate of return for the host debt instrument.
**EXAMPLE 1-2**

Debt issued at par, puttable upon a change in control

FG Corp issues a fixed-rate debt instrument with a term of five years, at par value. The debt contains a put option that allows the lender to put the debt when there is a change in control (defined in the debt agreement), and receive 105% of the debt’s par value. FG Corp determines that a change in control during the next five years is unlikely.

Is the embedded put option clearly and closely related to the debt host?

*Analysis*

FG Corp performs the analysis in Figure 1-1 as illustrated below.

Based on the analysis, the embedded put option is considered clearly and closely related to its debt host. It should not be accounted for separately.
EXAMPLE 1-3
Debt issued at a premium, puttable upon a change in control

FG Corp issues a fixed-rate debt instrument with a term of five years, at 102% of par value. The debt contains a put option that allows the lender to put the debt when there is a change in control (defined in the debt agreement), and receive par value.

Is the embedded put option clearly and closely related to the debt host?

Analysis

FG Corp performs the analysis in Figure 1-1 as illustrated below.

- **Does exercise of the put option accelerate the repayment of the debt?**
  - Yes, the put option requires the issuer to repay the debt instrument at par value upon exercise of the put option.

- **Is the amount paid upon exercise of the put option based on changes in an index?**
  - No, upon exercise of the put option, the investor will receive the par value of the bond.

- **Does the debt involve a substantial premium or discount?**
  - No, the debt was issued at 102% of par value; thus, the premium is less than 10% of the par value of the bond. There is no premium received upon exercise of the put option.

- **Is the put option based solely on interest rates? If yes, perform the analysis to determine whether there is an interest rate derivative that should be accounted for separately.**
  - The put option is solely based on a change in control; therefore, it is not based solely on interest rates. As such, the put option would not be analyzed under the guidance in ASC 815-15-25-26.

Based on the analysis, the embedded put option is considered clearly and closely related to its debt host. It should not be accounted for separately.
**EXAMPLE 1-4**

Debt issued at a discount, puttable upon a change in control

FG Corp issues a fixed-rate debt instrument with a term of five years, at 80% of par value. The debt contains a put option that allows the lender to put the debt when there is a change in control (defined in the debt agreement), and receive par value.

Is the embedded put option clearly and closely related to the debt host?

**Analysis**

FG Corp performs the analysis in Figure 1-1 as illustrated below.

Based on the analysis, the embedded put option is not considered clearly and closely related to its debt host. It should be accounted for separately as a derivative based on the guidance in ASC 815.

**1.6.2 Indexed debt instruments**

Some debt instruments have embedded components that provide for returns that are indexed to an underlying other than interest rates or the creditworthiness of the reporting entity. For example, a
Debt instruments may be indexed to the price of the reporting entity’s equity, creditworthiness of a referenced pool of debt securities, commodities such as oil or natural gas, or the S&P 500 index.

ASC 815-15-25-1 provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative. Embedded components which index a debt instrument to a reporting entity’s own equity often qualify for the scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a); therefore, these embedded components are generally not separated and accounted for as a derivative.

Many embedded components which index a debt instrument to an index unrelated to the reporting entity (e.g., natural gas, S&P 500) often meet the requirements for derivative separation; therefore, these instruments are often accounted for as a debt host contract and a separate derivative. See DH 4 for information on embedded derivatives.

If the embedded component is not required to be separately accounted for as a derivative under ASC 815, the guidance in ASC 470-10-25-4 and ASC 470-10-35-4 should be applied to the indexed debt instrument.

**ASC 470-10-25-4**

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.

**ASC 470-10-35-4**

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.

Inflation bonds are commonly issued indexed debt instruments. In general, inflation in the economic environment in which a debt instrument is issued is considered clearly and closely related to a debt instrument; therefore, the indexation to inflation within an inflation bond typically does not meet the requirements for derivative separation. ASC 815-15-55-202 and ASC 815-15-55-203 and DH Question 4-11 provide examples illustrating when an inflation bond should be separated into a derivative and a debt host instrument.

**1.6.3 Contingent interest**

Some debt instruments pay additional interest only when certain conditions exist. For example, the amount of interest to be paid may be based on a reporting entity’s stock price, credit rating, or dividends declared on a reporting entity’s common stock. Other contingent interest provisions include payment of additional interest contingent on the occurrence of certain events. For example, additional
interest is paid to investors upon a change in tax law (e.g., changes in allowable withholding or deductions) that increases the tax obligation of certain investors.

A contingent interest feature that meets the definition of a derivative is considered clearly and closely related to a debt host when indexed *solely* to interest rates or the reporting entity’s credit risk. Consistent with the analysis of indexed debt instruments discussed in FG 1.6.2, if the contingent interest feature is based on an index that is unrelated to the reporting entity, the feature should be separated and accounted for as a derivative.

Certain contingent interest provisions meet the definition of a registration payment arrangement within the scope of ASC 825-20-15-3. See FG 1.7.1 for information on registration payment arrangements.

The determination of the likelihood of paying contingent interest should be consistent for book and tax purposes. That is, if a reporting entity determines that the value of a contingent interest feature is not material because the likelihood of payment is remote, then the same assertion should be used when determining if the interest is deductible for tax purposes. See TX 9.4.2 for information on the tax accounting considerations of contingent interest.

### 1.7 Other arrangements

A reporting entity may execute agreements in connection with the issuance of a debt instrument. In the following sections, we describe two of the more common agreements.

#### 1.7.1 Registration payment arrangements

Registration rights allow the holder to require that the reporting entity file a registration statement for the resale of specified instruments and may be provided to lenders in the form of a separate agreement, such as a registration rights agreement, or included as part of an investment agreement, such as an investment purchase agreement, warrant agreement, debt indenture, or preferred stock indenture. These arrangements may require the issuer to pay additional interest in the event that a registration statement is not filed or is no longer effective.

The ASC Master Glossary provides a definition of a registration payment arrangement.

**Definition from ASC Master 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:

3. 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

4. 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).

ASC 825-20-15-4 provides exceptions to the provisions of the registration payment arrangement guidance.

**ASC 825-20-15-4**

The guidance in this Subtopic does not apply to any of the following:

a. Arrangements that require registration or listing of convertible debt instruments or convertible preferred stock if the form of consideration that would be transferred to the counterparty is an adjustment to the conversion ratio. (Subtopic 470-20 provides guidance on accounting for convertible instruments with contingently adjustable conversion ratios.)

b. Arrangements in which the amount of consideration transferred is determined by reference to either of the following:

1. An observable market other than the market for the issuer’s stock
2. An observable index.

For example, if the consideration to be transferred if the issuer is unable to obtain an effective registration statement is determined by reference to the price of a commodity. See Subtopic 815-15 for related guidance.

c. Arrangements in which the financial instrument or instruments subject to the arrangement are settled when the consideration is transferred (for example, a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares that are issuable upon exercise of the warrant is not declared effective by the SEC within a specified grace period).

There is no recognition of a registration payment arrangement unless transfer of consideration under the arrangement is probable and the payment amount or a range of payment amounts can be reasonably estimated. In that case, the contingent liability under the registration payment arrangement should be included in the allocation of proceeds from the related financing transaction. The remaining proceeds should then be allocated to the financial instruments issued based on the provisions of other US GAAP. For example, if a registration payment arrangement relates to debt issued with warrants, the registration payment proceeds should be recognized and measured under ASC 450, Contingencies, first, then the remaining proceeds should be allocated between the debt and warrants.

Any change in the value of the estimated contingent liability should be recognized in the income statement.
Question 1-5 addresses the accounting for convertible debt with a contingent interest escalation clause.

**Question 1-5**

A reporting entity issues convertible debt with an initial coupon rate of 6% per annum. If the reporting entity does not complete a qualified IPO within 18 months of the convertible debt being issued, then the coupon will increase in accordance with a specified schedule set forth in the debt agreement.

How should the reporting entity account for the convertible debt with the contingent interest escalation clause?

**PwC response**

The contingent escalation clause is a contingent obligation to pay additional interest that meets the definition of a registration payment arrangement within the scope of ASC 825-20. Accordingly, the reporting entity should recognize the contingent obligation to pay additional interest using the guidance in ASC 450-20-25. That is, a liability should be recorded once payment is probable and the payment amount, or a range of payment amounts, can be reasonably estimated.

If, at issuance, payment under the contingent escalation clause is not probable (or the range of payment amounts cannot be reasonably estimated), the convertible debt should be measured without regard to the contingent obligation to pay additional interest. See FG 6 for information on the accounting for convertible debt.

If payment under the escalation clause is probable when the debt is issued, and the payment amount or a range of payment amounts can be reasonably estimated, the proceeds received from the convertible debt should be first allocated to the contingent liability and then allocated to the convertible debt. If payment under the escalation clause becomes probable after the debt is issued, and the payment amount or a range of payment amounts can be reasonably estimated, a contingent liability should be recorded with an offsetting entry to the income statement.
Chapter 2: Guarantees and joint and several obligations
2.1 Chapter overview

A guarantor may guarantee financial or operational performance for a number of reasons. Common types of guarantees include financial guarantees, performance guarantees, indemnifications, and indirect guarantees of another entity’s debt. Guarantees are often embedded in purchase or sales agreements, service contracts, joint venture agreements, or other commercial arrangements.

A joint and several liability is an obligation of several parties that is enforceable, for the full amount of the obligation, against any one of the parties. For example, in a joint and several debt obligation, the lender can demand payment in accordance with the terms of the debt for the total amount of the obligation from any one, or a combination, of the obligors. Reporting entities under common control may be jointly and severally liable for an obligation; but so may unrelated reporting entities.

This chapter discusses the accounting considerations associated with guarantees from the perspective of the guarantor. It also discusses the accounting considerations for joint and several liability arrangements. This chapter does not discuss disclosure requirements. See FSP 23 for information related to disclosures.

2.2 Accounting for a guarantee under ASC 460

ASC 460, Guarantees contains guidance on a guarantor’s accounting and disclosure requirements for particular guarantee obligations. It requires a reporting entity that makes certain types of guarantees to recognize a liability generally measured initially at fair value, and to make a number of specified disclosures. For other types of guarantees, the guarantor is exempt from the initial recognition provisions, but is still subject to the disclosure requirements. Both financial and nonfinancial contracts can be guarantees within the scope of ASC 460. The scope does not include guarantees that the guarantor should record in equity. Figure 2-1 summarizes the key steps in the application of ASC 460, each of which is discussed in more detail in later sections.

Figure 2-1
Framework for application of ASC 460
2.3 Determining whether a contract is a guarantee

ASC 460-10-15-4 provides a list of contract types that should be accounted for as a guarantee unless it qualifies for a scope exception. See FG 2.3.1 through 2.3.4 for information on each of these types of guarantees. See FG 2.4 for information on the types of guarantees excluded from the scope of ASC 460.

Excerpt from ASC 460-10-15-4

Except as provided in paragraph 460-10-15-7, the provisions of this Topic apply to the following types of guarantee contracts:

a. Contracts that contingently require a guarantor to make payments…to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

b. Contracts that contingently require a guarantor to make payments…to a guaranteed party based on another entity’s failure to perform under an obligating agreement (performance guarantees).

c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party.

d. Indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

Guarantees of an underlying related to an asset, liability or equity security of the guaranteed party are accounted for under ASC 460 if the underlying is a separate instrument of the guaranteed party.

The payment required to be made by guarantors is not limited to payments in cash; a guarantee can require payment in cash, financial instruments, other assets, shares of the guarantor’s stock, or by providing services. Some securitizations, as well as other arrangements, may involve the subordination of the rights of some investors to the rights of others. Economically, while the subordinated investors provide credit protection, as a payment is not made, these arrangements are not in the scope of ASC 460.

Question 2-1 discusses if commercial letters of credit and loan commitment guarantees are within the scope of ASC 460.

Question 2-1

Commercial letters of credit and other loan commitments are often thought of as funding guarantees. Are commercial letters of credit and loan commitments guarantees within the scope of ASC 460?

PwC response

No. Commercial letters of credit and loan commitments do not guarantee payment of an obligation and they do not provide for payment if the borrower defaults. ASC 460-10-15-4 requires the guarantor
to make a payment for the guarantee to be within the scope of ASC 460; many commercial letters of credit and loan commitments include material adverse change clauses that enable the guarantor to avoid making a payment. Additional information on material adverse change clauses can be found in FSP 12.

Question 2-2 discusses if a weather derivative is a guarantee within the scope of ASC 460.

**Question 2-2**

Is a weather derivative a guarantee within the scope of ASC 460?

**PwC response**

No. To be within the scope of ASC 460-10-15-4(a), the payments made to the guaranteed party must be based on changes in an underlying that is related to an asset, liability or equity of the guaranteed party. A geological variable is not an asset, a liability or equity of the guaranteed party. A weather derivative also does not meet the criteria in ASC 460-10-15-4(b), ASC 460-10-15-4(c) and ASC 460-10-15-4(d).

### 2.3.1 Financial guarantees

ASC 460-10-55-2 provides examples of financial guarantee contracts that may be within the scope of ASC 460. Insurance companies that issue financial guarantee contracts must assess whether they are within the scope of ASC 944, *Insurance*, before considering ASC 460.

**ASC 460-10-55-2**

The following are examples of contracts of the type described in paragraph 460-10-15-4(a) [contracts that contingently require a guarantor to make payments]:

a. A financial standby letter of credit

b. A market value guarantee on either a financial asset (such as a security) or a nonfinancial asset owned by the guaranteed party

c. A guarantee of the market price of the common stock of the guaranteed party

d. A guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity

e. A guarantee granted to a business or its owner(s) that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified amount.

In each of these contracts, the guarantor is contingently obligated to make payment and is unable to avoid payment.
2.3.1.1 Put options

A put option is a market value guarantee. The holder of a put option has the right to sell a specified amount of an underlying to the writer of the put option at a specified price on a specified date or dates. For example, Guarantor G may provide Company X with the right to put its investment in the common stock of a private company to Guarantor G for $10 at a future date. If the value of the common stock is below $10 at that date, Company X would likely exercise its put option.

To determine whether a put option should be accounted for as a guarantee within the scope of ASC 460, the put option writer (i.e., the reporting entity) should first determine whether it meets the requirements to be accounted for as a derivative in ASC 815, Derivatives and Hedging. If so, it is not a guarantee within the scope of ASC 460. See DH 2 for information on determining whether a put option should be accounted for as a derivative, and DH3 for information on the scope exception for certain financial guarantee contracts. In practice, a written put option often is not in the scope of ASC 460.

Next, the put option writer should assess whether the put option holder has an asset or liability relating to the underlying on or about inception of the put option. To meet the definition of a guarantee in ASC 460-10-15-4(a), the put option must be on an underlying related to an asset, liability or equity security of the guaranteed party (i.e., the put option holder). If the guarantor cannot conclude it is probable that the put option buyer has an asset or liability related to the underlying, then the option is not a guarantee within the scope of ASC 460. A put option also does not meet the scope criteria in ASC 460-10-15-4(b), ASC 460-10-15-4(c) and ASC 460-10-15-4(d). For purposes of measurement, the guarantor should assess whether the put option buyer still holds the asset or liability related to the underlying each period.

A put option that requires the holder to deliver the underlying instrument (i.e., a gross settled option) may be in the scope of ASC 460 if the put option is on an underlying related to an asset, liability or equity security of the guaranteed party. For instance, if an investor separately (1) buys a non-puttable bond, and (2) enters into a freestanding put option that can only be settled by delivery of the bond, the put option will be a guarantee within the scope of ASC 460 if the bond is held by the guaranteed party (unless one of the scope exceptions identified in ASC 460-10-15-7 apply).

2.3.1.2 Minimum revenue guarantees

In a minimum revenue guarantee, the revenue of a guaranteed party is guaranteed to reach a minimum amount during the guaranteed period. The revenue amount guaranteed may be total revenue, revenue from a specific product line, or some other revenue amount. A minimum revenue guarantee is typically granted to a business or its owners. The guarantor should assess whether the minimum revenue guarantee is within the scope of ASC 460.

Question 2-3 discusses if a licensing agreement with a guaranteed minimum royalty payment contains a guarantee within the scope of ASC 460.
Question 2-3

Consider an agreement that grants a reporting entity the right to manufacture, have manufactured, purchase, sell, market and distribute the products of another entity for a one year period. Royalty payments are based on a percentage of actual sales of licensed products but there is a minimum royalty payment of $1 million. Does the licensing agreement contain a guarantee within the scope of ASC 460?

PwC response

Yes, a minimum royalty payment is a minimum revenue guarantee within the scope of ASC 460. The reporting entity has guaranteed that another entity will receive at least $1 million either through actual sales or through a royalty payment.

2.3.2 Performance guarantees

There are a number of different types of performance guarantees that may be within the scope of ASC 460. ASC 460-10-55-12 provides the following examples.

ASC 460-10-55-12

The following are examples of contracts of the type described in paragraph 460-10-15-4(b):

a. Performance standby letters of credit
b. Bid bonds
c. Performance bonds
d. Other contracts that are similar to performance standby letters of credit.

A bid bond is a type of a performance guarantee common in the construction industry, which may be within the scope of ASC 460. In a bid bond, a contractor guarantees that they will complete a project for the amount that they bid. If not, the contractor would need to pay the difference between their bid, and the next closest bid.

In a performance guarantee, the guarantor agrees to perform the obligations under a contract upon the occurrence of a specified contingent event. Those obligations may be those of the guarantor (e.g., a contractor guarantees its own past performance), or those of a third party (i.e., a guarantor performs the obligations under a contract if the third party cannot). See FG 2.4.3 for information on guarantees of a reporting entity’s own performance.

In practice, questions often arise regarding whether certain types of performance guarantees and indemnifications are within the scope of ASC 460. A guarantor that guarantees a third party’s past or future performance is in the scope of ASC 460. A guarantor can guarantee its own past performance under ASC 460, but a guarantor cannot guarantee its own future performance under ASC 460.
2.3.3 Indemnifications

ASC 460-10-55-13 provides three examples of indemnifications that may be a guarantee within the scope of ASC 460.

ASC 460-10-55-13

The following are examples of contracts of the type described in paragraph 460-10-15-4(c):

a. An indemnification agreement (contract) that contingently requires the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law.

b. A lessee’s indemnification of the lessor for any adverse tax consequences that may arise from a change in the tax laws, because only a legislative body can change the tax laws, and the lessee therefore has no control over whether payments will be required under that indemnification. In contrast ... when a lessee indemnifies a lessor against adverse tax consequences that may arise from acts, omissions, and misrepresentations of the lessee, that indemnification is outside the scope of this Topic because the lessee is, in effect, guaranteeing its own future performance.

c. A seller’s indemnification against additional income taxes due for years before a business combination, because the indemnification relates to the seller-guarantor’s past performance, not its future performance.

Example 2-1 illustrates an indemnification of a service provider that is within the scope of ASC 460. Example 2-2 illustrates a contract that indemnifies a subsidiary’s past actions.

EXAMPLE 2-1

Indemnification of a service provider

Consumer Corp enters into a contract to obtain services from Service Inc. The terms of the contract include a provision in which Consumer Corp agrees to indemnify and “hold harmless” Service Inc for all third party claims relating to the services provided to Consumer Corp, with the exception of any claims resulting from willful misconduct or gross negligence on the part of Service Inc.

Does the contract contain a guarantee within the scope of ASC 460?

Analysis

Yes, the indemnification is a guarantee within the scope of ASC 460 because it contingently requires Consumer Corp to make payments to Service Inc based on the occurrence of a third party claim, which is related to a liability of Service Inc.

In this example, the indemnification relates to the performance of Service Inc, not Consumer Corp; therefore, it is not eligible for the scope exception in ASC 460-10-15-7(i) related to its own future performance. See FG 2.4 for information on scope exceptions.
EXAMPLE 2-2
Indemnification of a subsidiary’s past actions

LCD Corp sells its subsidiary, Subsidiary Inc, to FG Corp. As part of the sales agreement, LCD Corp agrees to indemnify the directors and officers of FG Corp for any third party claims and matters that may arise related to Subsidiary Inc’s past actions.

Does the sales agreement contain a guarantee within the scope of ASC 460?

Analysis

Yes, the indemnification is a guarantee within the scope of ASC 460 because it is not dependent upon Subsidiary’s (or LCD’s) future performance, but rather on its past performance. LCD is guaranteeing to reimburse the directors and officers of FG Corp for any future claims related to Subsidiary Inc’s past performance.

2.3.4 Indirect guarantees of the indebtedness of others

An indirect guarantee of indebtedness requires that the guarantor make a payment to the debtor upon the occurrence of specified events under conditions whereby (1) once the funds are transferred from the guarantor to the debtor, the funds become legally available to creditors as a result of their claims against the debtor, and (2) those creditors can enforce the debtor’s claims against the guarantor under the agreement. An indirect guarantee of indebtedness ensures the borrower will have sufficient funds to repay its creditors. ASC 460-10-20 provides examples of indirect guarantees.

Partial definition from ASC 460-10-20

Examples of indirect guarantees include agreements to advance funds if a debtor’s net income, coverage of fixed charges, or working capital falls below a specified minimum.

A guarantee of the debt of a third party is generally within the scope of ASC 460.

2.4 ASC 460 scope exceptions

ASC 460-10-15-7 provides a number of scope exceptions. When a reporting entity has a contract that is not in the scope of ASC 460, it should apply other applicable US GAAP. This can result in guarantees being accounted for using a variety of different accounting standards including leasing, revenue recognition, derivatives, and insurance.

ASC 460-10-15-7

The guidance in this Topic does not apply to the following types of guarantee contracts:

a. A guarantee or an indemnification that is excluded from the scope of Topic 450 (see paragraph 450-20-15-2—primarily employment-related guarantees)

b. A lessee’s guarantee of the residual value of the underlying asset at the expiration of the lease term under Topic 842.
c. A contract that meets the characteristics in paragraph 460-10-15-4(a) but is accounted for as variable lease payments under Topic 842.

d. A guarantee (or an indemnification) that is issued by either an insurance entity or a reinsurance entity and accounted for under Topic 944 (including guarantees embedded in either insurance contracts or investment contracts)

e. A contract that meets the characteristics in paragraph 460-10-15-4(a) but provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party

f. A contract that provides for payments that constitute a vendor rebate (by the guarantor) based on the volume of purchases by the buyer (because the underlying relates to an asset of the seller, not the buyer who receives the rebates)

g. A guarantee or an indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee’s underlying or recognize in earnings the profit from that sale transaction

h. A registration payment arrangement within the scope of Subtopic 825-20 (see Section 825-20-15)

i. A guarantee or an indemnification of an entity’s own future performance (for example, a guarantee that the guarantor will not take a certain future action)

j. A guarantee that is accounted for as a credit derivative at fair value under Topic 815.

k. A sales incentive program in which a manufacturer contractually guarantees to reacquire the equipment at a guaranteed price or guaranteed prices at a specified time, or at specified time periods (for example, the entity is obligated to reacquire the equipment or the entity is obligated at the customer’s request to reacquire the equipment). That program shall be evaluated in accordance with Topic 606 on revenue from contracts with customers, specifically the implementation guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78.

Employment related guarantees such as vacation pay, pension costs, deferred compensation contracts, and stock issued to employees are generally scoped out of ASC 460.

2.4.1 Indemnification of officers and directors

A reporting entity may indemnify its officers or directors against litigation that arises in connection with the fulfillment of their normal functions. The indemnification is considered part of the officers’ or directors’ compensation package.

Since guarantees outside the scope of ASC 450 are also excluded from the scope of ASC 460, and ASC 450-20-15-2(a) excludes employment-related costs from its scope, indemnification of an officer or director against litigation is not within the scope of ASC 460.
2.4.2 **Guarantees that prevent sale accounting**

ASC 460-10-55-17 provides examples of guarantees that are outside the scope of ASC 460 because they prevent sale accounting.

**ASC 460-10-55-17**

The following are examples of contracts that are outside the scope of this Topic because they are of the type described in paragraph 460-10-15-7(g):

a. A seller’s guarantee of the return of a buyer’s investment or return on investment of a real estate property as discussed in paragraph 360-20-40-41.

b. A seller’s guarantee of a specified level of operations of a real estate property, as discussed in paragraphs 360-20-40-42 through 40-44.

c. A transaction that involves sale of a marketable security to a third-party buyer with the buyer having an option to put the security back to the seller at a specified future date or dates for a fixed price, if the existence of the put option prevents the transferor from accounting for the transaction as a sale, as described in paragraphs 860-20-55-20 through 55-23.

d. A seller-lessee’s residual value guarantee if that guarantee results in the seller-lessee deferring profit from the sale greater than or equal to the gross amount of the guarantee (see paragraphs 840-40-55-26 through 55-28).

e. A sales incentive program in which a manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, if that guarantee prevents the manufacturer from being able to account for a transaction as a sale of an asset, as described in paragraphs 840-10-55-12 through 55-25. (Because a manufacturer continues to recognize the residual value of the equipment it guaranteed [it is included in the seller-lessee’s net investment in the lease], if the sales incentive program qualified to be reported as a sales-type lease, it still would not be within the scope of this Topic because this Topic does not apply to a guarantee for which the underlying is related to an asset of the guarantor.)

Example 2-3 illustrates a guarantee that is outside the scope of ASC 460 because it prevents sale accounting.

**EXAMPLE 2-3**

Impact of sale accounting on accounting for guarantees

FG Corp manufactures equipment and sells it to a third party finance company. The finance company then leases the equipment under an operating lease to an end user lessee. To facilitate the sale, FG Corp provides the finance company with the following guarantees:

- A credit guarantee to protect the finance company from losses incurred from default by the lessee
☐ A residual value guarantee to protect the finance company from decreases in the fair value of the equipment, when it is returned by the end user at the end of the lease term, below a specified threshold.

Should the FG Corp account for the guarantees under the guidance in ASC 460?

**Analysis**

FG Corp determines that the guarantees cause it to retain a substantial risk of ownership in the equipment; thus, sale accounting is precluded under the guidance in ASC 840, *Leases*.

Because the guarantees preclude sale accounting, they qualify for the scope exception in ASC 460-10-15-7. FG Corp should not account for the guarantees under the guidance in ASC 460.

### 2.4.3 Guarantees on a reporting entity’s own performance

Guarantees related to a reporting entity’s past performance are often within the scope of ASC 460. Guarantees related to a reporting entity’s future performance are not. For example, product warranties for goods are within the scope of ASC 460 because the warranted product was produced and sold in the past. On the other hand, a warranty on the guarantor’s future services is excluded from the scope of ASC 460 because it relates to the guarantor’s own future performance. Warranties on future service include warranties on completion of a contract by a specified deadline, and service contracts that guarantee a customer a specified amount of cost savings in the future.

In some cases, a reporting entity may need to assess whether a guarantee relates to its own performance or the performance of another entity to determine whether the scope exception for a guarantee of its own future performance should be applied. If a reporting entity has guaranteed its own past performance, it should still assess whether it qualifies for other scope exceptions within ASC 460.

Example 2-4 illustrates a guarantee that is outside the scope of ASC 460 because it is a guarantee of a reporting entity’s own future performance.

**EXAMPLE 2-4**

**Indemnification of performance under a joint business arrangement**

LCD Corp and FG Corp enter into a joint business arrangement. As part of the arrangement, LCD Corp and FG Corp agree to indemnify and “hold harmless” each other from any third party claims relating to their performance under the arrangement. Accordingly, LCD Corp agrees to indemnify FG Corp for claims related to LCD Corp’s performance under the joint business arrangement, and FG Corp agrees to indemnify LCD Corp for claims related to FG Corp’s performance.

Are the indemnifications guarantees within the scope of ASC 460?
Analysis

No, neither the indemnification that LCD Corp provides to FG Corp nor the indemnification that FG Corp provides to LCD Corp are within the scope of ASC 460 because each indemnification is related to the indemnitor’s own future performance under the joint business arrangement.

2.4.4 Credit derivatives

To determine whether a credit derivative is within the scope of ASC 460, a reporting entity should first determine whether the credit derivative contract should be accounted for as a derivative under the guidance in ASC 815. If the reporting entity is an insurance company, it must also consider the guidance in ASC 944. If a credit derivative is within the scope of ASC 815 or ASC 944, it should be accounted for using that guidance. If it is not within the scope of ASC 815 or ASC 944, it should be accounted for using the guidance in ASC 460.

2.5 Guarantees exempt from the recognition provisions

Certain types of guarantees are exempt from applying the recognition and measurement criteria of ASC 460. These guarantees are, however, still subject to the disclosure requirements of ASC 460. ASC 460-10-25-1 provides a list of contract types that are exempt from the recognition criteria.

ASC 460-10-25-1

The following types of guarantees are not subject to the recognition provisions of this Subsection:

a. A guarantee that is accounted for as a derivative instrument at fair value under Topic 815.

b. A product warranty or other guarantee for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party (see paragraph 460-10-15-9 for related guidance).

c. A guarantee issued in a business combination or an acquisition by a not-for-profit entity that represents contingent consideration (as addressed in Subtopics 805-30 and 958-805).

d. 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) (see Topics 480 and 505).

e. A guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligor (that is, principal debtor) under the original lease, as discussed in paragraph 840-30-40-5. This exception shall not be applied by analogy to secondary obligations that are not accounted for under that paragraph.

f. A guarantee issued either between parents and their subsidiaries or between corporations under common control.

g. A parent’s guarantee of its subsidiary’s debt to a third party (whether the parent is a corporation or an individual).

h. A subsidiary’s guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.
If a reporting entity issues a guarantee within the scope of ASC 460-10-25-1 to an entity under common control, it is exempt from recording a guarantee liability in both the consolidated and its separate financial statements. However, the reporting entity should provide disclosure related to the intercompany guarantee in its separate financial statements.

### 2.6 Initial measurement and recognition of a guarantee

A reporting entity that provides a guarantee is required to recognize the noncontingent component of the guarantee. They may also be required to recognize a contingent component.

The noncontingent component of a guarantee represents the obligation to stand ready to perform in the event that a specified triggering event or condition occurs. This component should be recorded as a guarantee liability at its fair value based on the guidance in ASC 460. See FG 2.6.1 for additional information.

The contingent component of a guarantee represents the obligation to make future payments if a triggering event or condition occurs. The contingent component is accounted for using the guidance in ASC 450, Contingencies, or in some situations, ASC 326, Credit Losses, as discussed in FG 2.6.2. Unlike the noncontingent component, the contingent component is only recorded if payment of the guarantee is probable, which is typically not the case at inception of the guarantee.

#### 2.6.1 Initial measurement of the noncontingent component of a guarantee

A guarantee recognized as a liability under the guidance in ASC 460 should be initially recognized at fair value at issuance. This is the noncontingent component of the guarantee.

When a guarantee is independently issued in a standalone arm’s-length transaction with an unrelated party, it is generally recognized at an amount equal to the amount paid for the guarantee as a practical expedient.

When a guarantee is issued as part of a transaction with multiple elements (such as in conjunction with selling an asset or entering into an operating lease), the guarantor should measure the fair value by determining the amount that would have been charged to issue the same guarantee in a standalone arm’s-length transaction. A reporting entity should evaluate all facts, circumstances, and business practices to develop a process to identify guarantees included in other contracts that should be accounted for under ASC 460.

When there is no observable data for identical or similar guarantee transactions, as is often the case, the measurement of a guarantee will require the use of estimates. A reporting entity should develop valuation models which consider all relevant facts and circumstances, to determine the fair value of its guarantees. Reporting entities often use a discounted cash flow model to determine the fair value but other models may also be appropriate.

In determining the fair value of a guarantee under ASC 460, a reporting entity should apply the principles in ASC 820, *Fair Value Measurement*. See FV 4 for additional information regarding the key concepts in applying ASC 820.
2.6.2 Initial measurement of the contingent component of a guarantee

At inception of a guarantee, the guarantor should also assess the need to recognize a liability for the contingent component of the guarantee (the obligation to make future payments under the guarantee) using the guidance in ASC 450-20-25.

ASC 460-10-30-3

In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under Section 450-20-25 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of the following:

a. The amount that satisfies the fair value objective as discussed in the preceding paragraph
b. The contingent liability amount required to be recognized at inception of the guarantee by Section 450-20-30.

Liabilities recognized using the guidance in ASC 450 are measured at the maximum amount of any potential payment and are typically not discounted. That said, payments are only measured once they are considered probable. As discussed in ASC 460-10-30-4, it is unusual for the contingent liability recognized in accordance with ASC 460-10-30-3(b) to exceed the fair value amount to be recognized at inception under the guidance in ASC 460-10-30-3(a). ASC 460-10-30-4 discusses two scenarios when that may occur:

- At inception, it is probable that the guarantor will be required to pay the maximum potential settlement at the end of the term, and there is some likelihood that the guarantor will not be required to make any payment at the end of the term. Measuring the guarantee liability at fair value would require the consideration of the likelihood that no payment will be required. However, the accrual of the contingent loss under ASC 450-20-30 would be based solely on the best estimate of the probable settlement amount (the maximum potential settlement amount in this example).

- A contingent liability that is expected to occur well in the future. Under ASC 450-20-S99-1, the contingent liability is often undiscounted, which will likely exceed a guarantee liability recorded at fair value, which takes into account the time value of money.

2.6.2.1 Initial measurement of the contingent component of a guarantee within the scope of ASC 326

The guidance in ASC 326, Financial Instruments – Credit Losses, will be effective beginning in 2020. The guidance on the measurement of the contingent component of a guarantee not accounted for as insurance will be amended when the guidance in ASC 326 becomes effective, as discussed in ASC 460-10-25-2 and ASC 460-10-30-5.

Excerpt from ASC 460-10-25-2 (as amended)

For guarantees that are within the scope of Subtopic 326-20, the expected credit losses (the contingent aspect) shall be measured and accounted for in addition to and separately from the fair value of the guarantee (the noncontingent aspect) in accordance with paragraph 460-10-30-5.
ASC 460-10-30-5

At the inception of a guarantee within the scope of Subtopic 326-20 on financial instruments measured at amortized cost, the guarantor is required to recognize both of the following as liabilities:

a. The amount that satisfies the fair value objective in accordance with paragraph 460-10-30-2.

b. The contingent liability related to the expected credit loss for the guarantee measured under Subtopic 326-20.

For more information on the application and effective dates of ASC 326, see PwC's Loans and investments guide.

2.6.3 Recognition of a guarantee

When a reporting entity records a guarantee liability, the offsetting entry will depend on the specific facts and circumstances that gave rise to the guarantee. ASC 460 does not prescribe a specific account for the offsetting entry; however, ASC 460-10-55-23 provides illustrative examples for various types of guarantees.

ASC 460-10-55-23

Although paragraph 460-10-25-4 does not prescribe a specific account, the following illustrate a guarantor’s offsetting entries when it recognizes the liability at the inception of the guarantee:

a. If the guarantee were issued in a standalone transaction for a premium, the offsetting entry would be consideration received (such as cash or a receivable).

b. If the guarantee were issued in conjunction with the sale of assets, a product, or a business, the overall proceeds (such as the cash received or receivable) would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from the sale. That allocation would affect the calculation of the gain or loss on the sale transaction.

c. If the guarantee were issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method, the recognition of the liability for the guarantee would result in an increase to the carrying amount of the investment.

d. If a residual value guarantee were provided by a lessee-guarantor when entering into an operating lease, the offsetting entry (representing a payment in kind made by the lessee when entering into the operating lease) would be reflected as prepaid rent, which would be accounted for under Section 840-20-25.

e. If a guarantee were issued to an unrelated party for no consideration on a standalone basis (that is, not in conjunction with any other transaction or ownership relationship), the offsetting entry would be to expense.
A reporting entity may also provide a guarantee on behalf of an equity method investee. When a reporting entity provides such a guarantee, it should evaluate whether the guarantee affects its accounting for the equity method investee. Example 2-5 illustrates the accounting for a guarantee made on behalf of an equity method investee.

**EXAMPLE 2-5**

**Guarantee of a loan made to an equity method investee**

FG Corp has an equity method investment in Investee Co.

Investee Co borrowed money from Bank Corp, a third party lender. In connection with the borrowing, FG Corp issues a guarantee of Investee Co’s repayment of its loan. FG Corp is the only investor in Investee Co that issues a guarantee. FG Corp does not receive any consideration for the guarantee. Although Bank Corp would have made the loan to Investee Co without the guarantee, the cost of borrowing is reduced as a result of it. FG Corp and the other investors in Investee Co benefited from the reduced borrowing cost.

How should FG Corp account for its guarantee of Investee Co’s borrowing?

**Analysis**

FG Corp first determines the amount of the guarantee related to its ownership interest in Investee Co by performing a pro rata calculation using the fair value of the guarantee. Based on the pro rata calculation, a portion of the guarantee will be an increase to the equity method investment, and a portion of the guarantee will be expensed. FG Corp concludes that a portion of the guarantee should be an increase to the equity method investment by analogizing to ASC 460-10-55-23(c). FG Corp concludes that the remaining portion of the guarantee should be expensed by analogizing to ASC 323, *Equity Method and Joint Ventures*. ASC 323-10-25-3 discusses the accounting when one investor grants stock-based compensation to the employees of an equity method investee. The contributing investor must expense the portion of the costs of the grant that exceeds its proportionate ownership percentage.

**2.7 Subsequent measurement of a guarantee**

ASC 460 does not prescribe a method for subsequently measuring and recording the noncontingent guarantee liability. As stated in ASC 460-10-35-1, the guarantee liability should generally be reduced by recording a credit to net income as the guarantor is released from the guaranteed risk.

ASC 460-10-35-2 discusses three methods that can be used to subsequently recognize the guarantor’s release from risk.
**Excerpt from ASC 460-10-35-2**

Depending on the nature of the guarantee, the guarantor’s release from risk has typically been recognized over the term of the guarantee using one of the following three methods:

a. Only upon either expiration or settlement of the guarantee

b. By a systematic and rational amortization method

c. As the fair value of the guarantee changes.

ASC 460 does not provide guidance regarding when each of these methods should be used. A reporting entity should determine which method is most appropriate based on the nature of each guarantee. For example, the risk related to a guarantee of amortizing debt may be reduced as each payment is made. Therefore, a systematic and rational amortization method based on when the payments are made may be appropriate. A guarantor should not recognize a guarantee at fair value each period, as discussed in ASC 460-10-35-2(c), unless carrying the guarantee at fair value is appropriate based on other US GAAP (i.e., the guarantee should be accounted for under ASC 815 or the fair value option is elected).

In addition to subsequently measuring and recognizing the noncontingent component of a guarantee as discussed above, a reporting entity should continually assess the contingent component of the guarantee. The contingent component of a guarantee should be recognized using the guidance in ASC 450, unless the guarantee meets the definition of a derivative under ASC 815 or is considered an insurance contract under ASC 944. If so, the contingency should be accounted for using those standards. See DH 2 for further information on the definition of a derivative.

If recognition of a contingent component is required, a reporting entity should record it at the amount required by ASC 450, less the current carrying amount of the noncontingent component recognized in accordance with ASC 460. A reporting entity should separately track these components and account for them in accordance with their respective subsequent accounting guidance.

2.7.1 **Subsequent accounting for a guarantee within the scope of ASC 326**

The guidance regarding the subsequent measurement of a guarantee in ASC 460-10-35-4 will be amended when the guidance in ASC 326 becomes effective.

**Excerpt from ASC 460-10-35-4 (as amended)**

For guarantees within the scope of Subtopic 326-20, the expected credit losses (the contingent aspect) of the guarantee shall be accounted for in accordance with that Subtopic in addition to and separately from the fair value of the guarantee liability (the noncontingent aspect) accounted for in accordance with paragraph 460-10-30-5.

For more information on the application and effective dates of ASC 326, see PwC’s *Loans and investments* guide.
2.8 Guarantee’s effect on accounting for other transactions

When guarantees are embedded in other contracts, a reporting entity should assess whether the guarantee affects the accounting for that contract.

2.8.1 Fixed-price trade-in guarantee’s effect on revenue recognition

A manufacturer may grant its customers the right to trade in, at a fixed price, equipment purchased from the manufacturer and use the trade-in proceeds to purchase new equipment from the manufacturer. The customer typically will only exercise this fixed-price trade-in right if the fair value of the equipment has decreased below the price specified in the trade-in arrangement. In a fixed-price trade-in agreement, the manufacturer guarantees the trade-in value of its equipment. Many of these agreements are guarantees within the scope of ASC 460.

Not all fixed-price trade-in agreements are guarantees within the scope of ASC 460. For example, a reporting entity sells Product X.1 (version 1) currently and plans to sell Product X.2 (version 2) in 6 months. If a customer purchases Product X.1 with a fixed-price trade-in right because Product X.2 is not yet available, the customer is using Product X.1 on a temporary basis with the intent of trading it in for Product X.2. In substance, the customer is paying a fee for the use of Product X.1 and purchase of Product X.2. The reporting entity should recognize less than the full amount of the sale of Product X.1 and record deferred revenue such that it can recognize the full sales price of Product X.2. In these situations, rather than record a guarantee liability under ASC 460, the reporting entity must consider the multiple-element arrangement guidance in revenue recognition.

To determine whether the customer is making an independent decision to purchase Product X.1 and recognize the related revenue, the reporting entity should consider the following:

- The level of information on Product X.2 that was provided during the initial sales process
- Whether the customer takes physical delivery of Product X.1
- Whether the payment terms are linked to the delivery of Product X.2
- Whether the customer can use Product X.1 to meet his current needs

Reporting entities should also assess whether they have leased Product X.1 to the customer.

Example 2-6 illustrates the effect of a fixed-price trade-in right on revenue recognition when the trade-in right is exercised. Example 2-7 illustrates the effect of a fixed-price trade-in right on revenue recognition when the trade-in right is not exercised.

EXAMPLE 2-6

Fixed-price trade-in right – trade-in right is exercised

On January 1, 20X5, FG Corp offers a fixed-price trade-in right to all new customers that buy Product X.1 (version 1). The trade-in right allows customers to trade in Product X.1 for Product X.2 (version 2) when it is released on June 1, 20X5. Product X.1 sells for $10,000 and costs $3,800 to produce. Product X.2 will sell for $12,000 and costs $5,000 to produce.
Customers will be able to obtain Product X.2 by returning Product X.1 and paying an additional $6,000. The fixed-price trade-in right expires after one year.

FG Corp determines that the fixed-price trade-in arrangement is a guarantee within the scope of ASC 460; therefore, customers receive two deliverables, Product X.1 and a guarantee. The fair value of the guarantee is estimated to be $3,000 at the date of the sale. FG Corp will release the guarantee upon expiration or exercise.

On January 1, 20X5, FG Corp sells Product X.1 with the fixed-price trade-in right. On June 15, 20X5, the customer exercises his trade-in right to buy Product X.2. At that date, the estimated fair value of Product X.1 is $3,000.

How does FG Corp account for (1) the sale of Product X.1 and the fixed-price trade-in arrangement, and (2) the trade in of Product X.1 and purchase of Product X.2?

Analysis

FG Corp accounts for the guarantee under ASC 460 before applying the multiple element revenue recognition guidance in ASC 606, Revenue Recognition, to the sale of Product X.1 and the trade-in right guarantee. FG Corp then allocates the remaining consideration to the sale of Product X.1 and records the following journal entry on January 1, 20X5.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>Dr. Product X.1 cost of goods sold</td>
<td>$3,800</td>
</tr>
<tr>
<td>Cr. Revenue</td>
<td>$7,000</td>
</tr>
<tr>
<td>Cr. Guarantee liability</td>
<td>$3,000</td>
</tr>
<tr>
<td>Cr. Product X.1 inventory</td>
<td>$3,800</td>
</tr>
</tbody>
</table>

Based on the nature of the guarantee, FG Corp would release the recognized noncontingent portion of the guarantee at the time the customer trades in Product X.1 for X.2. Additionally, it would evaluate the guarantee liability on a quarterly basis to determine whether an adjustment is necessary to reflect the contingent portion of the guarantee, and would conclude that no adjustment is needed.

When the customer trades in Product X.1 and pays the additional $6,000 to purchase Product X.2, FG Corp recognizes the fair value of the Product X.1 inventory received ($3,000) as part of the consideration received.

FG Corp records the following entry on June 15, 20X5.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Cash</td>
<td>$6,000</td>
</tr>
<tr>
<td>Dr. Product X.1 inventory</td>
<td>$3,000</td>
</tr>
<tr>
<td>Dr. Product X.2 cost of goods sold</td>
<td>$5,000</td>
</tr>
<tr>
<td>Dr. Guarantee liability</td>
<td>$3,000</td>
</tr>
<tr>
<td>Cr. Revenue</td>
<td>$12,000</td>
</tr>
<tr>
<td>Cr. Product X.2 inventory</td>
<td>$5,000</td>
</tr>
</tbody>
</table>
EXAMPLE 2-7

Fixed-price trade-in right – trade-in right is not exercised

On January 1, 20X5, FG Corp offers a fixed-price trade-in right to all new customers that buy Product X.1 (version 1). The trade-in right allows customers to trade in Product X.1 for Product X.2 (version 2) when it is released on June 1, 20X5. Product X.1 sells for $10,000 and costs $3,800 to produce. Product X.2 will sell for $12,000 and costs $5,000 to produce.

Customers will be able to obtain Product X.2 by returning Product X.1 and paying an additional $6,000. The fixed-price trade-in right expires after one year.

FG Corp determines that the fixed-price trade-in arrangement is a guarantee within the scope of ASC 460; therefore, customers receive two deliverables, Product X.1 and a guarantee. The fair value of the guarantee is estimated to be $3,000 at the date of the sale. FG Corp will release the guarantee upon expiration or exercise.

On January 1, 20X5, FG Corp sells Product X.1 with the fixed-price trade-in right. The trade-in right is not exercised by the customer and expires on January 1, 20X6.

How does FG Corp account for the expiration of the fixed-price trade-in right?

Analysis

To account for the expiration of the fixed-price trade-in right, FG Corp records the following entry on January 1, 20X6.

Dr. Guarantee liability $3,000
Cr. Revenue $3,000

2.8.2 Vendor guarantees

Vendors often guarantee customers’ obligations to a finance company. When a vendor guarantees a third-party loan used to purchase its products or services, the vendor’s ability to recognize revenue may be affected.

The vendor should evaluate whether revenue should be recognized when it sells its products or services under payment terms similar to those of the third-party loan. This evaluation should be performed without regard to the mismatch in the cash collection date (i.e., if the purchase is financed through a third party lender, the vendor typically receives cash upfront whereas if the vendor provides similar payment terms, the cash is collected over time). If the vendor concludes that the fee is fixed or determinable and collectability is reasonably assured, then the transaction should be treated as a multiple-element arrangement.

If the vendor concludes that its customer guarantee is within the scope of ASC 460, it should allocate the revenue received from the third-party finance company to (1) the guarantee, based on its fair value as determined by ASC 460-10-30-2(b), and (2) apply the guidance in ASC 606-10-32-28 to any remaining deliverables.
If the vendor concludes that the revenue recognition criteria have not been met at inception of the transaction, all revenue should be deferred and recognized subsequently when the revenue recognition criteria have been met.

2.8.3 Guarantees effect on the sale of a business

It is common for a business combination to include various indemnification agreements which may meet the definition of a guarantee in ASC 460. For instance, when a seller indemnifies the acquirer from past foreign tax exposure exceeding a specified threshold, the indemnification is typically a guarantee within the scope of ASC 460. See TX 15 for further information on tax-related indemnifications. See BCG 2 for further information on indemnifications arising in a business combination.

When a reporting entity (i.e., the seller) accounts for an indemnification established by the terms of the sale of a business as a guarantee, the seller should record the guarantee liability as of the sale date. If a reporting entity recognizes a guarantee liability in connection with the sale of a business, it is asserting that its noncontingent obligation has a fair value greater than zero at the date of the sale. Such a guarantee recorded in connection with the sale of a business will affect the seller’s gain or loss on the sale.

A reporting entity should also consider the likelihood of having to return any sales proceeds for violations of the representations and warranties not included in the scope of ASC 460. Absent evidence to the contrary, general representations and warranties provided as a part of the sale of a business are assumed to be valid as of the sale date, and release of the consideration from escrow is expected at the end of the escrow period. Therefore, in most cases, the amounts held in escrow for general representations and warranties would be considered part of the consideration received for the sale of the business and included in determining the gain or loss on sale.

Example 2-8 illustrates the effect of escrow arrangements on the accounting for the sale of a business.

**EXAMPLE 2-8**

Effect of escrowed proceeds on accounting for the sale of a business

LCD Corp sells its subsidiary, Subsidiary Inc, to FG Corp for cash proceeds of $10 million. One million of the proceeds is put into an escrow account to be used to compensate FG Corp for any violations of the general representations and warranties listed in the purchase agreement. LCD Corp is not aware of any potential claims that may exist and has determined that the probability of a violation is insignificant (i.e., it considers the fair value of the noncontingent guarantee to be approximately zero). Barring any violations, the escrowed proceeds will be distributed to LCD Corp one year after the date of the sale.

How should LCD Corp account for the $1 million of sales proceeds put into escrow?

*Analysis*

LCD Corp should recognize the $1 million of escrowed proceeds as part of the proceeds from the sale of Subsidiary Inc on the date of sale because it has determined the probability of a violation is insignificant. LCD Corp should use the entire sales price of $10 million (which includes the $1 million in escrow) to calculate its gain or loss on the sale of Subsidiary Inc.
Guarantee’s effect on accounting for transfers of financial assets

A reporting entity may enter into a transaction to transfer a financial asset, a group of financial assets, or a participating interest in a financial asset. Transfers of financial assets may be accounted for by the transferor as sales or a secured borrowing. Whether a transfer of financial assets is accounted for as a sale or a secured borrowing depends on whether the transferor has relinquished control and the transferee has obtained control over the financial assets.

In assessing whether control has been transferred to the transferee, a reporting entity must consider whether the transferred financial assets have been isolated beyond the reach of the transferor, which requires assessing the continuing involvement of the transferor, if any. It is not unusual for a transferor to have continuing involvement in the form of a credit enhancement. This credit enhancement could be through a financial guarantee or retaining subordinated interests in assets sold to third parties. Having continuing involvement does not necessarily preclude a transferor from achieving sale accounting.

If a transfer of financial assets qualifies for sale accounting and the transferor provides a guarantee, it should be assessed under the guidance in ASC 460. A guarantee recorded in connection with the transfer of financial assets will affect the transferor’s gain or loss on the sale. As discussed in FG 2.3, providing subordination does not qualify as a guarantee under ASC 460 if the transferor is not required to make a payment. However, if the transferor is required to make a payment to the transferee, then the arrangement may qualify as a guarantee under ASC 460.

Joint and several liability

A joint and several liability is an obligation shared by several parties that is enforceable, for the full amount of the obligation, against any one of the parties. For example, in a joint and several debt obligation, the lender can demand payment in accordance with the terms of the debt for the total amount of the obligation from any one, or a combination, of the obligors. An obligor cannot refuse to pay the total obligation on the basis that they individually only borrowed a portion of the total proceeds; however, they may be able to pursue the other obligors for repayment, depending on the agreement among the co-obligors and the laws covering the arrangement.

Joint and several liabilities can exist between entities that are under common control or between unrelated parties. Entities under common control may participate in a financing arrangement in which each entity borrows a specified amount, but are jointly and severally liable for repayment of the total debt incurred by the group. An example of joint and several liability among unrelated parties is a legal dispute when the courts hold all of the defendants jointly and severally liable for the damages awarded.

ASC 405-40, Obligations Resulting from Joint and Several Liability Arrangements, provides guidance on accounting for joint and several liabilities.

Joint and several obligations within ASC 405-40

ASC 405-40-15-1 and 15-2 provide guidance on the scope of ASC 405-40.
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.

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.

A reporting entity should consider its agreements to determine whether a contract creates a joint and several liability arrangement or is a guarantee. For example, a joint venture between two unrelated parties may obtain financing from a bank. If the bank is required to demand repayment from the joint venture first, and only upon nonperformance by the joint venture can the bank demand repayment from the two reporting entities that formed the joint venture, then the reporting entities may not have joint and several liability. The reporting entities may instead have a guarantee that should be accounted for under ASC 460.

2.9.2 **Measurement and recognition of joint and several liabilities**

ASC 405-40-30-1 provides guidance on measuring obligations under joint and several liability arrangements, both initially and in subsequent periods. The guidance in ASC 405-40-30-1 requires a reporting entity to record, at a minimum, its portion of the joint and several liabilities. A reporting entity cannot avoid recording a liability simply because it does not believe it will pay.
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.

When applying the guidance above, a reporting entity should not apply a probability weighted threshold to determine the amount it expects to pay on behalf of its co-obligors (e.g., a reporting entity should not follow a more-likely-than-not threshold).

The offsetting entry or entries (e.g., cash, an expense, a receivable, an equity transaction) will depend on the specific facts and circumstances of the transaction to which the joint and several liability arrangement relates.

Example 2-9 illustrates the application of the scope guidance for obligations related to joint and several liability arrangements. Example 2-10 illustrates the application of the scope guidance for obligations related to joint and several liability arrangements upon the issuance of a judicial ruling.

**EXAMPLE 2-9**

**Joint and several litigation liability arrangements**

LCD Corp and FG Corp jointly marketed a product. A lawsuit is brought against both LCD Corp and FG Corp claiming that the product posed a threat to the public. Under government laws and regulations for the product, LCD Corp and FG Corp are jointly and severally liable. The litigation is still ongoing; however, both reporting entities believe that a loss is probable and can be reasonably estimated.

Should LCD Corp and FG Corp record an obligation under ASC 405-40 as a result of their joint and several liability arrangement?

**Analysis**

No. The litigation is ongoing and therefore the obligation is not fixed at the reporting date. Since there is no fixed obligation at the reporting date, LCD Corp and FG Corp should not record a joint and several obligation. They should each record a contingency using the guidance in ASC 450.
EXAMPLE 2-10

Judicial ruling

LCD Corp and FG Corp jointly marketed a product. A lawsuit is brought against both LCD Corp and FG Corp claiming that the product posed a threat to the public. Under government laws and regulations for the product, LCD Corp and FG Corp are jointly and severally liable.

When the case is completed and a judicial ruling has been given, the total judgment is $10 million. Under the terms of their joint and several liability arrangement LCD Corp and FG Corp are each required to pay $5 million, but are jointly and severally liable for the total judgment amount of $10 million. In addition, the parties must also pay interest on the award through the settlement date.

Should LCD Corp and FG Corp record a liability using the guidance in ASC 405-40?

Analysis

Yes. The amount is now considered fixed at the reporting date and LCD Corp and FG Corp have an obligation under a joint and several liability arrangement; therefore, they are within the scope of ASC 405-40. The fact that the award accrues interest until it is settled does not affect the conclusion that the amount of the liability has been fixed at the reporting date.

2.9.2.1 Recoveries

If a reporting entity pays an amount in excess of its share of a joint and several liability, it may be able to demand repayment from its co-obligors. ASC 405-40 does not provide guidance on recording recoveries under a joint and several liability arrangement. Depending on the facts and circumstances, a reporting entity may determine that some of the payment can be recovered, and would either record a receivable or treat the recovery as a gain contingency.

If a reporting entity has a contractual right to demand repayment from its co-obligors, then it may be appropriate to record a receivable. The receivable should be continually assessed for impairment. If the reporting entity does not have a contractual right to demand repayment, then the recovery should be treated as a gain contingency. For example, if a reporting entity does not have a contractual right to demand repayment, but intends to sue its co-obligors, then the recovery should be accounted for as a gain contingency. A reporting entity should also consider the relationship between the co-obligors to determine the appropriate accounting for the recovery. When co-obligors are related parties, a recovery may need to be accounted for as an equity or capital transaction.

Once the guidance in ASC 326 is effective, impairment of receivables will be assessed using the current expected credit loss model. For more information on the application and effective dates of ASC 326, see PwC’s Loans and investments guide.

Example 2-11 and Example 2-12 illustrate the considerations when accounting for a recovery.
EXAMPLE 2-11

Recording a joint and several liability recovery as a receivable

Subsidiary Inc and Branch Inc are wholly owned subsidiaries of FG Corp. Subsidiary Inc and Branch Inc collectively borrow $50 million and are both identified as being jointly and severally obligated for the full amount of the debt in the borrowing arrangement. Subsidiary Inc uses $20 million for its corporate purposes and Branch Inc uses $30 million for its corporate purposes. Subsidiary Inc and Branch Inc have entered into a supplemental written agreement which enables each to obtain a recovery from the other should they pay an amount in excess of the amount of proceeds received.

The bank demands repayment in full on the debt from Subsidiary Inc, because Branch Inc is experiencing financial difficulty. Subsidiary Inc repays the full $50 million obligation.

How should Subsidiary Inc account for the amount it is owed from Branch Inc?

Analysis

Subsidiary Inc should record a receivable for $30 million because Subsidiary Inc and Branch Inc have a legally enforceable arrangement under which each party is responsible for repaying the amount it borrowed. Subsidiary Inc should assess the receivable for impairment and record an allowance for the amount considered uncollectible.

EXAMPLE 2-12

Recording a joint and several liability recovery as an equity transaction

Subsidiary Inc and Branch Inc are wholly owned subsidiaries of FG Corp. Subsidiary Inc and Branch Inc collectively borrow $50 million and are both identified as being jointly and severally obligated for the full amount of the debt in the borrowing arrangement. Subsidiary Inc uses $20 million for its corporate purposes and Branch Inc uses $30 million for its corporate purposes. Subsidiary Inc and Branch Inc have entered into a supplemental written agreement which enables each to obtain a recovery from the other should they pay an amount in excess of the amount of proceeds received.

FG Corp, the parent, directs Subsidiary Inc to write-off the amount otherwise recoverable from Branch Inc under the supplemental agreement.

How should the nonpayment by Branch Inc be recognized by Subsidiary Inc and Branch Inc?

Analysis

FG Corp’s decision to override the terms of the agreement, which requires Branch Inc to repay Subsidiary Inc, is effectively an equity transaction between entities that are under common control. Accordingly, Subsidiary Inc should record the transaction as a dividend or a return of capital, as applicable, and not as a charge to the income statement as an uncollectible receivable. Branch Inc should similarly recognize a contribution of capital for its share of the original loan that it will not have to repay.
Chapter 3: Debt modification and extinguishment
3.1 Chapter overview

A reporting entity may modify the terms of its outstanding debt by restructuring its terms or by exchanging one debt instrument for another. A debt modification may be accounted for as (1) the extinguishment of the existing debt and the issuance of new debt, or (2) a modification of the existing debt, depending on the extent of the changes.

Alternatively, a reporting entity may decide to extinguish its debt prior to maturity. This may be due to a number of reasons, including changes in interest rates, credit rating, or its capital needs.

This chapter discusses the accounting for debt modifications and exchanges, including:

- Troubled debt restructurings (TDR)
- Modifications or exchanges of term loans or debt securities
- Modifications or exchanges of lines of credit or revolving-debt arrangements
- Modifications or exchanges of loan syndications or participations

This chapter also discusses the accounting for debt defeasances and extinguishments.

3.2 Analyzing a debt modification

A debt modification may be effected by:

- Amending the terms or cash flows of an existing debt instrument
- Exchanging existing debt for new debt with the same lender
- Repaying an existing debt obligation and contemporaneously issuing new debt to the same lender; although this may be a legal extinguishment, the transaction may need to be accounted for as a debt modification

When a reporting entity repays an existing debt obligation using the proceeds from a contemporaneous issuance of new debt to a different lender, the transaction should be accounted for as a debt extinguishment. See FG 3.7 for information on debt extinguishment accounting.

The sale of a debt instrument from one investor to another without the involvement of the reporting entity is not a transaction that should be recognized by the reporting entity; transactions among investors involving a reporting entity’s debt instruments do not affect the reporting entity’s accounting.
Debt modification and extinguishment

Figure 3-1 illustrates the steps to determine the accounting treatment of a debt modification.

**Figure 3-1**
Analyzing a debt modification

3.3 **Troubled debt restructuring**

A modification is a troubled debt restructuring (TDR) if (1) the borrower is experiencing financial difficulty, and (2) the lender grants the borrower a concession.

A debt restructuring that results in the full settlement of a debt obligation should be accounted for as a debt extinguishment; however, the borrower should still assess whether the restructuring is a TDR. Even when there is no remaining debt outstanding, the borrower is required to disclose the fact that the debt was extinguished as the result of a TDR in its financial statements. See FG 3.7 for further information on accounting for debt extinguishments.

If a borrower grants an equity interest to the lender as part of a restructuring, it should assess whether there is a change in control that results in push-down accounting (see BCG 13 for a discussion of push-down accounting). For example, if a reporting entity experiencing financial difficulty settles its debt by giving a lender a 95% equity interest in itself, and the lender elects push down accounting, the lender’s new basis will be pushed down to the reporting entity. In that case, the TDR may be recorded differently than described in this chapter.
3.3.1 Determining whether a borrower is experiencing financial difficulty

To determine whether it is experiencing financial difficulty, a borrower should first determine whether its creditworthiness has deteriorated since its debt was issued. ASC 470-60-55-7 provides guidance on evaluating changes in creditworthiness.

**Excerpt from ASC 470-60-55-7**

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.

If a borrower’s creditworthiness has not deteriorated based on the above guidance, any modification would not be considered a TDR.

If a borrower’s creditworthiness has deteriorated since its debt was originally issued, it should then assess all aspects of its current financial position to determine whether it is experiencing financial difficulty.

ASC 470-60-55-8 provides guidance on determining whether a borrower is experiencing financial difficulty. Notwithstanding those factors, if a borrower meets both of the conditions in ASC 470-60-55-9, it is not experiencing financial difficulty; therefore, its debt restructuring is not a TDR.

**Excerpt from ASC 470-60-55-9**

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):

a. 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.

b. 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.

If a borrower does not meet these conditions, or meets only one of these conditions, it should review the indicators listed in ASC 470-60-55-8 to determine whether it is experiencing financial difficulty.

**ASC 470-60-55-8**

All of the following factors are indicators that the debtor is experiencing financial difficulties:

a. The debtor is currently in default on any of its debt.

b. The debtor has declared or is in the process of declaring bankruptcy.
c. There is significant doubt as to whether the debtor will continue to be a going concern.

d. 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.

e. 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.

f. 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.

If a borrower determines that it is not experiencing financial difficulty, its debt restructuring is not a TDR. If it determines that it is experiencing financial difficulty, it should then determine whether its lender is granting a concession to determine whether the restructuring is a TDR.

### 3.3.2 Determining whether a lender is granting a concession

A lender is granting a concession when the effective borrowing rate on the restructured debt is less than the effective borrowing rate on the original debt. The effective borrowing rate of the restructured debt is calculated by solving for the discount rate that equates the present value of the cash flows under terms of the restructured debt to the current carrying amount of the original debt. ASC 470-60-55-11 through ASC 470-60-55-14 provides guidance on determining whether a lender is granting a concession.

**ASC 470-60-55-11**

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.

**ASC 470-60-55-12**

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.

**ASC 470-60-55-13**

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.
ASC 470-60-55-14

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).

Example 3-1 illustrates the process for determining whether a lender has granted a concession.

**EXAMPLE 3-1**

Determining whether a lender has granted a concession

FG Corp has a $1,000,000 term loan issued on January 1, 20X2, at a discount of $25,000.

The terms of FG Corp’s debt instrument as of December 31, 20X3 are:

<table>
<thead>
<tr>
<th>Terms</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding balance</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Remaining term</td>
<td>5 years</td>
</tr>
<tr>
<td>Maturity date</td>
<td>December 31, 20X8</td>
</tr>
<tr>
<td>Effective interest rate</td>
<td>5.86%</td>
</tr>
<tr>
<td>Unamortized discount</td>
<td>$17,857</td>
</tr>
<tr>
<td>Net carrying value</td>
<td>$982,143</td>
</tr>
<tr>
<td>Coupon</td>
<td>5.50%</td>
</tr>
<tr>
<td>Interest payments</td>
<td>Annually in December</td>
</tr>
<tr>
<td>Principal payment</td>
<td>Balloon payment at maturity</td>
</tr>
</tbody>
</table>
FG Corp is experiencing financial difficulty and on January 1, 20X4 negotiates a restructuring of its outstanding term loan. The following is a summary of the restructuring; there are no contingent payments in the restructured debt obligation.

### Modifications made

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal forgiveness</td>
<td>$100,000</td>
</tr>
<tr>
<td>New coupon</td>
<td>3.00%</td>
</tr>
<tr>
<td>Fair value of equity securities granted by FG Corp</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

Has FG Corp received a concession?

### Analysis

FG Corp should compare the effective interest rate of the restructured term loan with the effective interest rate of the original term loan. The effective interest rate of the restructured term loan would be determined by calculating the interest rate needed to equate the total payments on the modified debt, shown in the following table, to $932,143 (net carrying value of $982,143 less the $50,000 of equity).

<table>
<thead>
<tr>
<th></th>
<th>12/31/X4</th>
<th>12/31/X5</th>
<th>12/31/X6</th>
<th>12/31/X7</th>
<th>12/31/X8</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest payments</td>
<td>$27,000</td>
<td>$27,000</td>
<td>$27,000</td>
<td>$27,000</td>
<td>$27,000</td>
<td>$135,000</td>
</tr>
<tr>
<td>Principal payment</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>900,000</td>
<td>900,000</td>
</tr>
<tr>
<td>Total undiscounted cash flows on debt</td>
<td>$27,000</td>
<td>$27,000</td>
<td>$27,000</td>
<td>$27,000</td>
<td>$927,000</td>
<td>$1,035,000</td>
</tr>
</tbody>
</table>

$932,143 is the present value of $1,035,000 if the discount rate used is 2.24%. Because this effective interest rate is lower than the original term loan effective interest rate (5.86%), the bank has granted a concession. Because FG Corp is experiencing financial difficulty and has received a concession, the modification would be considered a TDR.

See Example 3-2 for guidance on how to record the TDR in this fact pattern.

### 3.3.3 Accounting for a TDR involving a modification of debt terms

When a borrower has a TDR in which the terms of its debt are modified, it should analyze the future undiscounted cash flows to determine the appropriate accounting treatment. The recognition and measurement guidance for a TDR depends on whether the future undiscounted cash flows specified by the new terms are greater or less than the carrying value of the debt. In calculating the future undiscounted cash flows specified by the new terms:

- All payments under the new terms should be included
Any contingent payments should be included without regard to the probability of those payments being made.

If the number of future payment periods may vary because the debt is payable on demand, the estimate of future cash payments should be based on the maximum number of periods that could be required under the terms of the revised debt agreement.

Figure 3-2 summarizes the accounting treatment for a TDR which results in a modification of the debt’s terms.

**Figure 3-2**
Accounting for a TDR resulting in a modification of terms

<table>
<thead>
<tr>
<th>If future undiscounted cash flows (including contingent payments) are:</th>
<th>Effect on gain recognition and interest expense</th>
<th>New fees paid to lender</th>
<th>New fees paid to third parties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than the net carrying value of the original debt</td>
<td>□ A gain is recorded for the difference</td>
<td>Reduce the recorded gain</td>
<td>Reduce the recorded gain</td>
</tr>
<tr>
<td></td>
<td>□ If the lender also holds equity securities, consider whether the gain should be recorded in equity. See FG 3.3.5 for further information</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>□ The carrying value of the debt is adjusted to the future undiscounted cash flow amount</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>□ No interest expense is recorded going forward</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>□ All future interest payments reduce the carrying value</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Greater than the net carrying value of the original debt</td>
<td>□ No gain is recorded</td>
<td>Capitalize and amortize</td>
<td>Expense</td>
</tr>
<tr>
<td></td>
<td>□ A new effective interest rate is established based on the carrying value of the original debt and the revised cash flows</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If a TDR involves a combination of actions, such as a partial settlement of the debt and a modification of the terms, the debtor should first reduce the debt’s carrying value by the fair value of the assets or equity interests transferred and then apply the modification of debt terms guidance to determine the appropriate accounting treatment.
Example 3-2 illustrates how to account for a TDR.

**EXAMPLE 3-2**

**Accounting for a troubled debt restructuring**

Assume the same facts as Example 3-1.

FG Corp determines that its term loan restructuring is a TDR because it is experiencing financial difficulty and its lender has granted a concession.

How does FG Corp account for the TDR?

**Analysis**

This restructuring involves both (1) a grant of equity securities from the borrower to the lender, and (2) a modification of terms. The calculation to determine if there is a gain associated with the TDR is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term loan carrying value</td>
<td>$982,143</td>
</tr>
<tr>
<td>Less: fair value of the equity securities granted by FG Corp</td>
<td>($50,000)</td>
</tr>
<tr>
<td>New net carrying value</td>
<td>$932,143</td>
</tr>
<tr>
<td>Less: future undiscounted cash flows</td>
<td>($1,035,000)</td>
</tr>
<tr>
<td>Difference</td>
<td>($102,857)</td>
</tr>
</tbody>
</table>

Because the future undiscounted cash flows under the new terms are greater than the adjusted net carrying value of the original debt, there is no gain to record.

A new effective interest rate is established based on the net carrying value of the debt and the revised cash flows. In this example, the new effective interest rate is 2.24%, as described in Example 3-1.

The following table shows the amortization of the new loan. The cash payments of $27,000 are calculated by multiplying the new coupon of 3.00% by the new outstanding balance of $900,000. The 12/31/X8 payment includes the balloon payment of $900,000 on the maturity date. Interest is calculated by multiplying the effective interest rate of 2.24% by the net carrying value of the debt.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash payment</th>
<th>Interest</th>
<th>Reduction of carrying value</th>
<th>Net carrying value</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X4</td>
<td>$27,000</td>
<td>$20,853</td>
<td>$6,147</td>
<td>925,996</td>
</tr>
<tr>
<td>12/31/X5</td>
<td>27,000</td>
<td>20,715</td>
<td>6,285</td>
<td>919,711</td>
</tr>
<tr>
<td>12/31/X6</td>
<td>27,000</td>
<td>20,574</td>
<td>6,426</td>
<td>913,285</td>
</tr>
<tr>
<td>12/31/X7</td>
<td>27,000</td>
<td>20,431</td>
<td>6,569</td>
<td>906,716</td>
</tr>
</tbody>
</table>
Debt modification and extinguishment

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash payment</th>
<th>Interest</th>
<th>Reduction of carrying value</th>
<th>Net carrying value</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X8</td>
<td>927,000</td>
<td>20,284</td>
<td>906,716</td>
<td>—</td>
</tr>
</tbody>
</table>

$1,035,000 $102,857 $932,143

3.3.4 TDR of a variable-rate instrument

ASC 470-60-35-11 provides guidance for TDRs involving an instrument with a variable interest rate.

**ASC 470-60-35-11**

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.

ASC 470-60-35-11 requires the cash interest payments used to calculate the future undiscounted cash flows to be based on the spot interest rate on the restructuring date. If the undiscounted future principal and interest payments, calculated at the restructuring date, are less than the carrying value of the debt, then a restructuring gain (equal to the difference) should be recognized. All future principal and interest payments should be recognized as a reduction to the carrying value of the debt. As a result, interest payments are not recognized as interest expense.

In the future, when interest rates change, actual cash flows will differ from the cash flows measured at the restructuring date. The accounting treatment for changes in cash flows due to changes in interest rates depends on whether there is an increase or decrease from the spot interest rate used in the initial TDR accounting (referred to as the “threshold interest rate”).

Upon an increase in interest rates, the borrower should recognize additional interest expense in the period the expense is incurred. The additional interest expense is calculated by multiplying the difference between the current rate and the threshold rate by the current carrying value of the debt for the current period only (i.e., it should not include changes in interest relative to future periods). ASC 470-60-35-11 indicates that the additional interest expense should be accounted for as a change in estimate in the period in which the change occurs.

A decrease in interest rates could result in an additional restructuring gain (or interest windfall) due to lower payments than those at the restructuring date. There is always a potential for future cash payments to offset a gain generated by an interest rate decrease (the variable rate could increase in the future); therefore, the gain should not be recognized until the debt is settled and there are no future

3-10
Debt modification and extinguishment

interest payments. The cash payments are applied against the carrying amount until it is settled and there is no possibility that the gain could be reduced by future interest rate increases.

When there are subsequent increases in interest rates above the threshold interest rate after a decrease in interest rates, we believe there are various acceptable alternatives to recognize the incremental interest above the threshold rate. Figure 3-3 summarizes two of these methods.

**Figure 3-3**
Accounting for incremental interest above the threshold rate in a TDR of a variable rate instrument

<table>
<thead>
<tr>
<th>Alternative</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current period method</td>
<td>□ Continue to use the original threshold interest rate to determine whether increases in interest rates result in incremental interest expense</td>
</tr>
<tr>
<td></td>
<td>□ Gains should be deferred until the point in time that the debt is settled and there are no future interest payments</td>
</tr>
<tr>
<td>Cumulative period method</td>
<td>□ Record all interest payments in excess of the original threshold interest rate as a reduction of the restructured debt’s carrying value until the prior interest windfall (described above) is recaptured on a cumulative basis. Thereafter, the original threshold interest rate should be used to determine whether increases in interest rates result in incremental interest expense.</td>
</tr>
</tbody>
</table>

A reporting entity should choose one of these methods and apply it consistently to similar instruments; the method applied should be disclosed in the financial statements if it is material.

### 3.3.5 Restructuring of debt by existing equity holders

If a lender holds equity securities of a borrower prior to a debt restructuring, it may be considered a related party. Transactions with equity holder lenders that benefit the borrower may be deemed capital transactions. This raises the issue of whether an extinguishment gain should be included in the borrower’s income statement or reflected as a contribution of capital. To make this determination, a borrower should consider the following points, with other relevant considerations, to determine the treatment of an extinguishment gain.

- The role of the related party lender in the restructuring
- The reason the related party lender agreed to a restructuring that resulted in the borrower recognizing an extinguishment gain (i.e., why the lender agreed to accept consideration of less than fair value)
- Whether other debt holders that do not own equity agree to a restructuring under similar terms
- Whether the substance of the restructuring was the forgiveness of debt owed to a related party

There is no specific guidance related to this issue; therefore, the appropriate accounting treatment requires judgment. However, if all debt holders have equity interests in the borrower, the debt
restructuring typically would be considered a capital transaction. In that case, the gain should be recorded in equity.

Determining the appropriate accounting treatment is more complicated when only some of the debt holders are also equity holders. A key consideration is whether the restructuring results in a significant shift in economics away from debt holders to equity holders. A significant transfer of value from the debt holders to different equity holders is characteristic of a typical TDR and should be recognized in income. If there are significant debt holders that do not own equity, that is a strong indicator that a gain should be recorded in the income statement and not in equity. Likewise, if significant equity holders own no debt, it is a strong indicator that a gain should be recorded in the income statement and not in equity.

This accounting analysis applies only to extinguishment gains. A TDR generally should not result in a loss because to qualify as a TDR, the lender has to have granted the borrower a concession.

### 3.4 Modification or exchange – term loan and debt security

The legal form of a modification transaction, whether a legal exchange or a legal amendment, is irrelevant for purposes of determining whether it is an accounting modification or extinguishment. The accounting treatment is determined by whether (1) the lender remains the same, and (2) the change in the debt terms is considered substantial.

A transaction involving the issuance of a new term loan or debt security to one lender (or investor) and the concurrent satisfaction of an existing term loan or debt security to another unrelated lender (or investor) is always accounted for as an extinguishment of the existing debt and issuance of new debt. See FG 3.7 for a discussion of debt extinguishment accounting and FG 1 for the accounting for the issuance of new debt. See FG 3.4.9 for information on the use of a third-party intermediary to facilitate an exchange.

Figure 3-4 provides a summary of the accounting for a debt modification or debt extinguishment when the lender remains the same.

**Figure 3-4**

Accounting for a debt modification and debt extinguishment

<table>
<thead>
<tr>
<th>Type of transaction</th>
<th>Debt</th>
<th>New fees paid to, or received from, existing lender</th>
<th>New fees paid to third parties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modification</td>
<td>□ No gain or loss is recorded □ A new effective interest rate is established based on the carrying value of the debt and the revised cash flows</td>
<td>Capitalize and amortize as part of the effective yield</td>
<td>Expense</td>
</tr>
</tbody>
</table>

### Type of transaction

<table>
<thead>
<tr>
<th>Debt</th>
<th>New fees paid to, or received from, existing lender</th>
<th>New fees paid to third parties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extinguishment</td>
<td>□ The old debt is derecognized and the new debt is recorded at fair value</td>
<td>Expense</td>
</tr>
<tr>
<td></td>
<td>□ A gain or loss is recorded for the difference between the net carrying value of the original debt and the fair value of the new debt. See FG 3.7 for further information</td>
<td></td>
</tr>
<tr>
<td></td>
<td>□ If the lender also holds equity securities, consider whether the gain should be recorded in equity. See FG 3.3.5 for further information</td>
<td></td>
</tr>
<tr>
<td></td>
<td>□ Interest expense is recorded based on the effective interest rate of the new debt</td>
<td></td>
</tr>
</tbody>
</table>

ASC 470-50-40-10 and 40-11 provide guidance on whether a modification or exchange of a term loan or debt security should be accounted for as a modification or an extinguishment.

**ASC 470-50-40-10**

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 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.)
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.

See FG 6.8 for information on the modification of convertible debt instruments.

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 lender to effect changes in:

- Recourse or nonrecourse features
- Priority of the obligation
- Collateralization features, including changes in collateral
- Debt covenants or debt covenant waiver terms
- The guarantor, or elimination of the guarantor
- Option features

ASC 470-50-40-11 provides specific guidance on performing the 10% test. Key takeaways from this guidance include:

- When performing the 10% test, the cash flows of the new debt instrument should include all amounts paid by the debtor to the lender (i.e., any fees paid to the lender in conjunction with the restructuring should be included in the cash flows of the new debt instrument) as a day-one cash flow
- Third-party fees should not be included in the cash flow analysis
- If there is a variable interest rate in any of the debt instruments, the spot interest rate on the restructuring date should be used to determine future interest payments
- If either debt instrument is callable or puttable, then separate cash flow analyses should be performed assuming exercise and nonexercise of the put and call. The scenario that generates the smallest change should be used. See FG 3.4.1 for further information on prepayment options
- For debt that has been amended more than once in a twelve-month period, the debt terms that existed just prior to the earliest amendment occurring in the prior twelve months should be used to apply the 10% test, provided modification accounting was previously applied. See FG 3.4.6 for further information

See FG 3.4.8 for information on exchanges of publicly traded debt securities, and FG 6.8 for information on modifications of convertible debt instruments.

Example 3-3 illustrates the application of the 10% test.
EXAMPLE 3-3
Applying the 10% test

FG Corp has a term loan that is not prepayable. Its credit rating has improved since the debt was issued, so FG Corp has decided to modify its debt to lower its borrowing costs and extend the term of its debt. Because FG Corp’s credit rating has improved, this restructuring is not considered a troubled debt restructuring.

The following table summarizes the terms of the original debt and new debt on the modification date.

<table>
<thead>
<tr>
<th></th>
<th>Original debt</th>
<th>New debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal amount</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Coupon</td>
<td>5.5%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Effective interest rate</td>
<td>6.0%</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Remaining term to maturity</td>
<td>3 years</td>
<td>5 years</td>
</tr>
<tr>
<td>Lender fees</td>
<td>Not applicable</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Should FG Corp account for the changes to its debt as a modification or an extinguishment?

Analysis

To perform the 10% test, the discounted cash flows of the original debt are compared to those of the new debt as of the modification date.

**Cash flows on original debt**

<table>
<thead>
<tr>
<th>Cash flows on original debt</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of $5,000,000 at the stated interest rate of 5.5% discounted at the original effective rate of 6% for 3 years</td>
<td>$4,933,175</td>
</tr>
</tbody>
</table>

**Cash flows on new debt**

<table>
<thead>
<tr>
<th>Cash flows on new debt</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of $5,000,000 at the new stated interest rate of 5% discounted at the original effective rate of 6% for 5 years</td>
<td>$4,789,382</td>
</tr>
<tr>
<td>Lender fees, undiscounted because it is a day one cash flow</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total cash flows</td>
<td>$4,989,382</td>
</tr>
</tbody>
</table>
FG Corp would calculate the change in cash flows as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of cash flows on new debt</td>
<td>$4,989,382</td>
</tr>
<tr>
<td>Present value of cash flows on original debt</td>
<td>$4,933,175</td>
</tr>
<tr>
<td>Change in present value of cash flows</td>
<td>$56,207</td>
</tr>
<tr>
<td>Percentage change</td>
<td>1.13%</td>
</tr>
</tbody>
</table>

Because the change in present value of cash flows is less than 10%, the change is considered a modification.

### 3.4.1 Prepayment options

Oftentimes, debt agreements allow a borrower to prepay the debt prior to maturity; this is especially common in variable rate debt instruments and bank loan syndications. A prepayment option is a call option that gives the borrower the right to call the debt from the lender and pay the amount owed.

ASC 470-50-40-12(c) provides guidance for applying the 10% test to debt instruments with prepayment options.

#### ASC 470-50-40-12(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.

If the change in cash flows is less than 10% in any scenario, then the restructuring is considered a modification.

If a prepayment option (or any put or call feature) is exercisable at any time, a borrower should assume it is exercised immediately. This will usually result in the smallest change in cash flows. When including prepayment options in the 10% test, it is not necessary to assess the ability of the borrower to prepay the debt; the 10% test should be applied to all noncontingent contractual scenarios.

When applying the 10% test, it may also be appropriate to consider contingent prepayment options, such as a call option exercisable upon a change in control, or upon completion of a qualified financing. Determining whether a contingent prepayment option should be included in a 10% test requires judgment based on the facts and circumstances at the modification date. For example, if it is probable that the contingent event that gives rise to exercise of the call option will occur, a cash flow scenario assuming exercise of the call should be performed. On the other hand, if the probability of the contingent event is remote, a contingent call or put option that is added to or deleted from a debt instrument is unlikely to be considered a substantial change and may not require further analysis.

Example 3-4 illustrates the application of the 10% test to a debt instrument with a prepayment option.
EXAMPLE 3-4
Applying the 10% test to debt with a prepayment option

FG Corp has a term loan that is prepayable without penalty. Its credit rating has improved since the debt was issued in August 20X3. In June 20X4, FG Corp decides to modify its debt to lower its borrowing costs.

The following table summarizes the terms of the original debt and new debt on the modification date.

<table>
<thead>
<tr>
<th></th>
<th>Original debt</th>
<th>New debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal amount</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Coupon</td>
<td>5.5%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Remaining term to</td>
<td>3 year</td>
<td>5 years</td>
</tr>
<tr>
<td>maturity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepayment feature</td>
<td>Can be prepaid at any time without penalty</td>
<td>Can be prepaid at any time with a 1% penalty</td>
</tr>
<tr>
<td>Lender fees</td>
<td>Not applicable</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

Should FG Corp account for the change to the provisions of its debt as a modification or an extinguishment?

Analysis

To perform the 10% test, FG Corp should assume that the prepayment option in both the original and new debt is exercised on the modification date. The related cash flows on the original debt and the new debt are shown below. Because all cash flows occur on day one, the cash flows are not discounted.

**Cash flows on original debt**

<table>
<thead>
<tr>
<th>Cash flows on original debt</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepayment of debt without penalty</td>
<td>$5,000,000</td>
</tr>
</tbody>
</table>

**Cash flows on new debt**

<table>
<thead>
<tr>
<th>Cash flows on new debt</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lender fees paid</td>
<td>$10,000</td>
</tr>
<tr>
<td>Prepayment of debt</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Prepayment penalty (1% × $5,000,000)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Total cash flows</td>
<td>$5,060,000</td>
</tr>
</tbody>
</table>
FG Corp calculates the change in cash flows as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows on new debt</td>
<td>$5,060,000</td>
</tr>
<tr>
<td>Cash flows on original debt</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Change in cash flows</td>
<td>$60,000</td>
</tr>
<tr>
<td>Percentage change in cash flows</td>
<td>1.2%</td>
</tr>
</tbody>
</table>

Because the change in cash flows in the immediate prepayment scenario is less than 10%, FG Corp should account for the changes to its debt as a modification. Because the prepayment scenario resulted in modification accounting, it is not necessary to prepare a cash flow scenario that does not assume prepayment.

### 3.4.2 Non-cash consideration

ASC 470-50-40-12(a) provides guidance on the cash flows of a new debt instrument to be included in the 10% test.

**ASC 470-50-40-12(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.

The term “any amounts paid,” as used in ASC 470-50-40-12(a), does not indicate if the amounts must be cash, or whether non-cash consideration, such as freestanding financial instruments like warrants or preferred stock, should be considered an amount paid. We believe the form of consideration should not affect the accounting. Treating warrants or preferred stock issued to a lender as a day-one cash flow is consistent with guidance in ASC 470-60-55-12 for TDRs, which requires the fair value of any new or modified non-cash consideration (e.g., options, warrants, guarantees, letters of credit) to be included in the calculation to determine whether a lender is granting a concession. If non-cash consideration is not exercisable for a period of time, that delay should be considered in determining its fair value.

If a restructuring is considered a modification based on the 10% test, then any non-cash consideration should be capitalized similarly to a cash fee paid to a lender. The capitalized amount, along with any existing unamortized debt discount or premium, should be amortized as an adjustment to interest expense over the remaining term of the modified debt instrument using the effective interest method.

If a restructuring is accounted for as a debt extinguishment, then the fair value of any non-cash consideration is associated with the extinguishment of the original debt instrument (i.e., treated as an amount paid to extinguish the debt) and included in determining the extinguishment gain or loss.
A debt modification may involve changes to embedded features (e.g., covenants, collateral, or seniority position) that have no effect on cash flows. Modifications to these non-cash terms would not impact the cash flows used for the 10% test.

### 3.4.2.1 Non-cash consideration issued to third party advisors

If warrants or preferred stock are issued to third-party advisors rather than the lender, we believe the fair value of the warrants or preferred stock should be accounted for following the guidance in ASC 470-50-40-18 for third-party costs. The accounting for third-party costs depends upon whether the restructuring is accounted for as a modification or an extinguishment. See Figure 3-4 for further information.

### 3.4.3 Change in currency of the debt

If a debt instrument is modified such that the currency in which it is denominated changes, the change in currency should be included in the cash flows as part of the 10% test. To convert the cash flows on the new debt into the currency of the original debt, we believe there are two acceptable methods, use (1) the spot rate in effect at the debt modification or exchange date, or (2) the forward rates corresponding to each cash flow (i.e., interest payment and principal) payment date.

### 3.4.4 Considerations when the restructured debt is the hedged item in a fair value hedge of interest rates

When performing the 10% test, the effect of the required amortization of basis adjustments due to the application of fair value hedge accounting should be ignored for the purposes of calculating the effective interest rate of the original debt instrument. The goal of the 10% test is to determine whether the terms of the relationship between the debtor and lender before and after a modification or exchange are substantially different. The fact that the debtor designated the debt as the hedged item in a fair value hedging relationship does not affect the relationship between the debtor and lender.

### 3.4.5 Change in principal

Application of the guidance to a term loan debt restructuring is more complicated when the principal balance changes as a result of the restructuring. Increases and decreases in the principal balance of a loan should be included in the cash flows of the new debt used to perform the 10% test based on the guidance in ASC 470-50-40-12(a), which specifically refers to considering “any” amounts paid or received by the debtor. If the principal received is net of a discount, the principal amount net of the discount should be used as the principal balance for purposes of applying this guidance.

An increase in principal should be treated as a day-one cash inflow in the cash flows of the new debt instrument, and a decrease should be treated as a day-one cash outflow.

A borrower should account for unamortized fees, new creditor fees, and third party costs in the same manner it would had there not been a change in principal. That is, when a loan is modified, unamortized fees should continue to be deferred, new creditor fees should be capitalized and amortized as part of the effective yield and new fees paid to third parties should be expensed. When a loan is extinguished, unamortized fees and new creditor fees should be expensed, and new fees paid to third parties should be capitalized and amortized as debt issuance costs associated with the new debt. See Example 3-7 for an illustration of the application of this guidance.
Question 3-1 discusses whether a portion of unamortized debt issuance costs should be expensed if a borrower pays down a portion of its debt under a prepayment option.

**Question 3-1**

If a borrower pays down a portion of its debt in accordance with an existing prepayment option, can a portion of the unamortized debt issuance costs associated with the debt balance be expensed?

**PwC response**

It depends on the borrower’s accounting policy.

Some borrowers continue to defer the unamortized debt issuance costs when they pay down a portion of their debt in connection with a modification (which is accounted for as a modification), based on the view that the prepayment is factored into the terms agreed to on the modified debt. In other words, they believe it is not possible to separately identify the prepayment amount.

Other reporting entities have a policy of expensing the portion of the unamortized costs associated with the partial pay down based on the guidance in ASC 470-50-40-2 because the debt has been partially settled. Since the debt has been partially settled, these reporting entities believe it is appropriate to consider the debt extinguishment guidance for the partial settlement.

This policy choice is not available when the original debt does not have an existing prepayment option or for a prepayment of debt made outside of a debt modification. See FG 3.7 for information on how unamortized fees should be accounted for in these circumstances.

### 3.4.6 Debt that has been restructured more than once within a one-year period

As discussed in ASC 470-50-40-12(f), if a debt instrument is restructured more than once in a twelve-month period, the debt terms (e.g., interest rate, prepayment penalties) that existed just prior to the earliest restructuring in that twelve-month period should be used to apply the 10% test, provided the restructuring was (or restructurings were) accounted for as a modification. In other words, this is a cumulative assessment in certain circumstances. Example 3-5 illustrates the application of the 10% test when debt has been restructured multiple times within a twelve-month period.

**EXAMPLE 3-5**

Multiple refinancing within a one-year period

This example is a continuation of Example 3-4.

FG Corp restructures its term loan again in December 20X4. It has made $2,000,000 of principal payments since it last restructured its term loan in June 20X4.
The following table summarizes the terms of the original debt and new debt on the restructuring dates.

<table>
<thead>
<tr>
<th></th>
<th>Original debt</th>
<th>June 20X4 amendment</th>
<th>December 20X4 amendment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal amount</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$3,000,000¹</td>
</tr>
<tr>
<td>Coupon</td>
<td>5.5%</td>
<td>5.0%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Remaining term to maturity at each restructuring date</td>
<td>3 years</td>
<td>5 years</td>
<td>4.5 years</td>
</tr>
<tr>
<td>Prepayment feature</td>
<td>Can be prepaid at any time without penalty</td>
<td>Can be prepaid at any time with a 1% penalty</td>
<td>Can be prepaid at any time with a 3% penalty</td>
</tr>
<tr>
<td>Lender fees</td>
<td>Not applicable</td>
<td>$10,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

¹ Reduced by $2,000,000 of normal principal payments made during the intervening period.

Should FG Corp account for the restructuring of its debt as a modification or an extinguishment?

**Analysis**

The cash flows used in each respective 10% test are as follows:

**June 20X4 restructuring:** As detailed in Example 3-4, the June 20X4 restructuring was accounted for as a modification. The cash flows used in that 10% test are shown below.

- Cash flows on new debt (see Example 3-4) $5,060,000
- Cash flows on original debt $5,000,000
- Change in cash flows $60,000
- Percentage change in cash flows 1.2%

**December 20X4 restructuring:** Because the December 20X4 restructuring was done less than twelve months after the June 20X4 restructuring, FG Corp must consider the terms that existed just prior to the June 20X4 restructuring (because there were no other restructurings within twelve months of December 31, 20X4 and prior to June 20X4) when determining the cash flows of the original debt. FG Corp should combine the June and December restructurings to determine if together these two restructurings resulted in more than a 10% change in cash flows as compared to the original debt in June 20X4. FG Corp would calculate the cash flows for this test as follows.
Debt modification and extinguishment

### Cash flows on original debt

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original cash flows</td>
<td>$5,000,000</td>
</tr>
</tbody>
</table>

### Cash flows on new debt

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lender fees paid in June 20X4 restructuring</td>
<td>$10,000</td>
</tr>
<tr>
<td>Normal principal payments made in intervening period</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Lender fees paid in December 20X4 restructuring</td>
<td>$5,000</td>
</tr>
<tr>
<td>Prepayment of debt</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Prepayment penalty (3% × $3,000,000)</td>
<td>$90,000</td>
</tr>
<tr>
<td><strong>Total cash flows</strong></td>
<td><strong>$5,105,000</strong></td>
</tr>
</tbody>
</table>

FG Corp calculates the change in cash flows as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows on new debt – December 20X4 restructuring</td>
<td>$5,105,000</td>
</tr>
<tr>
<td>Revised cash flows on original debt</td>
<td>$5,000,000</td>
</tr>
<tr>
<td><strong>Change in cash flows</strong></td>
<td><strong>$105,000</strong></td>
</tr>
<tr>
<td>Percentage change in cash flows</td>
<td><strong>2.1%</strong></td>
</tr>
</tbody>
</table>

Because the change is less than 10%, the December 20X4 restructuring will also be accounted for as a modification.

#### 3.4.7 Multiple debt instruments held by one lender

A borrower may have several debt instruments outstanding with one lender. When performing the 10% test, we generally believe all of a lender’s debt instruments should be included whether the debt was modified or not. However, in certain fact patterns, when it is clear that a modification is done without regard to other debt outstanding with the lender, it may be appropriate for a reporting entity to exclude certain debt instruments with the lender when performing the 10% test.

For example, if a borrower has two debt instruments outstanding with one lender, Tranche A and Tranche B, and the borrower (1) increases the principal balance of Tranche A, and (2) pays off Tranche B, the borrower should perform the 10% test by combining the cash flows of the original Tranche A and Tranche B debt instruments and comparing the combined cash flows to the new cash flows of the restructured Tranche A. When discounting the cash flows of the restructured Tranche A, we believe a
weighted average effective interest rate based on the original Tranche A and Tranche B interest rates should be used.

See FG 3.6.1 for information on costs associated with the concurrent modification of non-revolving (i.e., term debt) and revolving debt arrangements.

3.4.8 Application to publicly traded debt securities

ASC 470-50-55-3 provides guidance on applying the guidance in ASC 470-50-40 to publicly traded debt securities.

ASC 470-50-55-3

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.

There is no guidance on how to account for a refinancing of publicly traded debt securities that does not involve an exchange or modification offer (i.e., when a reporting entity issues new debt securities to investors, including holders of the issuer’s existing debt securities, and uses the proceeds to pay off existing publicly-traded debt securities held by the same investors). If a literal interpretation of ASC 470-50-55-3 is applied, each individual investor should be evaluated to determine whether the individual investor holds both the new and old debt securities. When the debt securities are publicly traded, this determination may be impossible because the borrower is not privy to the ultimate lender information. In that case, we believe it is reasonable to consider the substance rather than the form of the transaction. Unless the facts and circumstances indicate otherwise, we believe it is reasonable to assume that the investors in a new publicly-traded debt security are not the same as the investors in an existing publicly-traded debt security; therefore, the refinancing of publicly-traded debt securities should be accounted for as an extinguishment. This guidance may also be applicable to private placement debt instruments depending on the specific facts and circumstances and the information reasonably available with respect to the identities of the old and new investors.

Similar accounting may be appropriate for “refunding” transactions on tax-exempt municipal bonds. See ARM 9692.7434 for additional information.

3.4.9 Third-party intermediaries

A third-party intermediary (e.g., an investment bank) may arrange a debt modification or exchange offer for a reporting entity. For example:

- A reporting entity has multiple bonds issued under a single bond offering outstanding; the bonds are held by a number of third-party investors
- An investment bank and reporting entity negotiate a modification to the terms of the bonds
- The investment bank buys the bonds from the third-party investors
The terms are then modified pursuant to the modification agreement.

The investment bank sells the new bonds under the modified terms to third-party investors (who may, or may not, be the same as the investors in the original bonds).

To determine the appropriate accounting treatment for a modification or exchange transaction arranged by a third-party intermediary, a reporting entity should determine whether the intermediary is a principal to the transaction (i.e., the investor in the bonds whose terms were modified) or the reporting entity’s agent (i.e., facilitating a refunding of the old bonds on behalf of the reporting entity through issuance of new debt).

ASC 470-50-55-7 provides indicators to be considered in evaluating whether a third-party intermediary is acting as principal or an agent.

**ASC 470-50-55-7**

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.

There is a general presumption that a third-party intermediary is acting as an agent; however, this presumption can be overcome. The first indicator in ASC 470-50-55-7 is the most important; the third-party intermediary should be exposed to market risk to conclude it is acting as principal to the transaction. A reporting entity should evaluate all of the facts and circumstances to determine whether the third-party intermediary has funds at risk with regard to both the old bonds and new bonds. The following points should be considered.

- **The period the third-party intermediary will hold the new debt instruments before selling them.** The holding period should be long enough to expose the third-party intermediary to sufficient market risk to conclude it is a principal to the transaction; how long that period is will vary from transaction to transaction. For example, if a third-party intermediary holds debt instruments for less than one day (that is, buying the bonds and reselling them intra-day or obtaining bids prior to, or concurrent with, an exchange), it is generally not subject to sufficient market risk to be a principal to the transaction.

- **Whether the new debt instruments will be sold on a best-efforts or firmly committed basis.** A third-party intermediary may be acting as principal if the debt instruments are sold on a firmly committed basis, which requires the bank to hold any debt instruments that it is unable to sell to others. On the other hand, when a third-party intermediary sells new debt instruments under a best-efforts agreement it indicates that the bank is acting as the reporting entity’s agent. Under a best-efforts agreement, an agent agrees to buy only those debt instruments that it is able to sell to others; if the agent is unable to sell the debt instruments, the reporting entity is obligated to buy the debt instruments back.

- **Computation of the fee to be paid to the third-party intermediary by the reporting entity.** If the third-party intermediary sets the interest rate on the new debt so that it is commensurate with the combined market and credit risk to which it is exposed, without including costs for hedging that risk, the third-party intermediary may be considered a principal to the transaction. On the other hand, if a third-party intermediary includes the cost of hedging its market risk associated with holding the new debt during the agreed-upon minimum holding period, it has not placed its own funds at risk, and is acting as the reporting entity’s agent. In addition, if the underwriting fees paid to the third-party intermediary by the reporting entity are higher than in similar market transactions, the reporting entity should assess whether the third-party intermediary is exacting a higher fee to reduce its exposure to market risk. In that case, the third-party intermediary may have limited its funds at risk, and may be acting as the reporting entity’s agent.

If the third-party intermediary acts as an agent, the reporting entity has refinanced the original debt with new debt to other third party investors and the reporting entity should consider the guidance in FG 3.4.8.
If the third-party intermediary is considered a principal to the transaction, it is the investor. In that case, the reporting entity should perform the 10% test based on the cash flows of the debt held by the third-party intermediary before and after the modification or exchange.

### 3.4.10 Allocation of debt issuance costs incurred to raise new debt and extinguish existing debt

When a reporting entity issues new debt and uses the proceeds to pay off existing debt, it may incur issuance costs with the same party to (1) issue the new debt, and (2) reacquire the existing debt. For example, a reporting entity may use the same advisor to issue a tender offer for its existing debt and a private placement of its new debt. If the costs associated with each transaction are not separately identifiable, the reporting entity should allocate the total costs incurred between the issuance of the new debt and the reacquisition of the existing debt, on a rational basis.

### 3.4.11 Fees paid in advance of restructuring of debt

A reporting entity may incur costs directly related to a debt modification or exchange that crosses a reporting period. To determine whether the costs should be capitalized as a prepaid expense or expensed in the period incurred, a reporting entity should consider the guidance in ASC 340-10-S99-1, SAB Topic 5.A, Expenses of Offering. Although this guidance relates to costs incurred in advance of an equity offering, we believe it can be analogized to costs incurred in advance of a debt restructuring. Based on that analogy, we believe that fees directly related to a debt restructuring incurred in advance of finalizing the transaction should be capitalized as a prepaid expense until the restructuring is finalized, unless facts and circumstances indicate that it is probable that the restructuring will be aborted or it is probable that the fees will be required to be expensed once the transaction is finalized in the subsequent period under the guidance in ASC 470-50-40. If it is probable that the restructuring will be aborted or that the fees will be expensed in the following period, they do not meet the definition of an asset (i.e., there is no probable future economic benefit) and should not be capitalized.

For example, if a reporting entity incurred legal fees in advance of a debt restructuring and it finalized the debt restructuring transaction shortly after the balance sheet date, the reporting entity would likely have the information to assess the transaction using the guidance in ASC 470-50-40. If the reporting entity determined that the debt restructuring should be accounted for as a modification in the subsequent period, that guidance would require that all third party fees be expensed. Therefore, by analogy to ASC 340-10-S99-1, the reporting entity should expense those legal fees in the period incurred because it is probable as of the balance sheet date that the fees would be expensed in the subsequent period.

If the reporting entity had not finalized its debt restructuring prior to issuing the financial statements and the reporting entity did not have enough information to determine if the transaction will be a modification or extinguishment in the subsequent period, the legal fees should be capitalized as a prepaid expense in the period incurred. However, we typically would not expect a long time lag between incurring such costs and the finalization of the debt restructuring since the costs must be directly related to the restructuring.

Once the debt restructuring is completed, the fees should be accounted for using the guidance in ASC 470-50-40. See Figure 3-4 for further information on the accounting treatment for fees.
3.4.12 Parent’s involvement in a consolidated subsidiary’s debt

On a consolidated basis, the debt of a consolidated subsidiary represents debt of the parent. Therefore, if debt of a consolidated subsidiary is exchanged for debt of the parent company, the guidance in ASC 470-50-40 should be applied to determine whether the exchange should be accounted for as a modification or an extinguishment in the consolidated financial statements.

A parent company may also acquire the debt of a consolidated subsidiary for cash. When this occurs, the requirements for extinguishment accounting in the subsidiary’s standalone financial statements are generally not met; however, on a consolidated basis, the consolidated entity has reacquired its own debt so extinguishment accounting is appropriate. See FG 3.7 for information on accounting for a debt extinguishment.

3.5 Modification or exchange – line of credit and revolving-debt arrangements

A line of credit, or revolving-debt arrangement, is an agreement that provides the borrower with the ability to borrow money as needed (up to a specified maximum amount), repay portions of its previous borrowings, and reborrow under the same contract. Line of credit and revolving-debt arrangements may include both amounts drawn by the borrower (a debt instrument) and a commitment by the lender to make additional amounts available to the borrower under predefined terms (a loan commitment). Generally, a borrower incurs costs to establish a line of credit or revolving-debt arrangement; some or all of the costs are deferred and amortized over the term of the arrangement.

When a drawn line of credit or revolving-debt arrangement is modified, the borrower should first determine whether it is a TDR. See FG 3.3 for further information on TDRs.

If the modification is not a TDR, the borrower should apply the guidance in ASC 470-50-40-21 provided the lender before and after the modification is the same.

**ASC 470-50-40-21**

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.

The assessment described in ASC 470-50-40-21 should be made on a lender by lender basis. If a lender exits the line of credit completely, then all unamortized costs associated with that lender should be expensed.

Example 3-6 illustrates the accounting treatment for unamortized costs and new fees in a modification of a revolving-debt arrangement.

EXAMPLE 3-6
Accounting for unamortized costs and new fees in revolving-debt arrangements

FG Corp has a line of credit. FG Corp decides to modify the line of credit arrangement to extend the term and reduce the commitment amount.

The following table summarizes the terms of the original line of credit and the new line of credit on the modification date.

<table>
<thead>
<tr>
<th></th>
<th>Original line of credit</th>
<th>New line of credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original term</td>
<td>5 years</td>
<td>4 years</td>
</tr>
<tr>
<td>Remaining term</td>
<td>3 years</td>
<td>4 years</td>
</tr>
<tr>
<td>Commitment amount</td>
<td>$10,000,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Unamortized debt</td>
<td>$200,000</td>
<td>Not applicable</td>
</tr>
<tr>
<td>issuance costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>New third party fees</td>
<td>Not applicable</td>
<td>$10,000</td>
</tr>
<tr>
<td>New lender fees</td>
<td>Not applicable</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

How should FG Corp account for the unamortized debt issuance costs related to the original line of credit and the new third-party and lender fees?

Analysis

To determine the accounting treatment for the unamortized debt issuance costs and new fees, the borrowing capacity of the original arrangement is compared to the borrowing capacity of the new arrangement. Borrowing capacity is calculated as the commitment amount multiplied by the remaining term of the arrangement.
## Debt modification and extinguishment

### Borrowing capacity on original line of credit

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total commitment amount</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Remaining term</td>
<td>3 years</td>
</tr>
<tr>
<td>Original borrowing capacity</td>
<td>$30,000,000</td>
</tr>
</tbody>
</table>

### Borrowing capacity on new line of credit

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total commitment amount</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Remaining term</td>
<td>4 years</td>
</tr>
<tr>
<td>New borrowing capacity</td>
<td>$20,000,000</td>
</tr>
</tbody>
</table>

The borrowing capacity decreased by $10,000,000, or 33%. Therefore, 33% of the unamortized costs ($66,000) should be expensed in the current period. The remaining unamortized debt issuance costs should be amortized over the term of the new arrangement.

The new lender fees and third-party fees should be capitalized and amortized over four years, which is the term of the new arrangement.

### Modification or exchange – loan syndication and participation

Many financing arrangements involve multiple lenders that are members of a loan syndicate or loan participation. The accounting for a modification of a loan syndication differs from that of a loan participation.

Figure 3-5 summarizes how to perform the 10% test for a loan syndication and loan participation.

#### Figure 3-5
10% test for loan syndication and loan participation

<table>
<thead>
<tr>
<th>Description</th>
<th>Loan syndication</th>
<th>Loan participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Each lender has a separate loan with the borrower</td>
<td>The lead lender has a loan with the borrower; participating lenders have an interest represented by a certificate of participation</td>
<td></td>
</tr>
<tr>
<td>The borrower performs the 10% test separately for each lender in the syndication</td>
<td>The borrower performs the 10% test for the entire loan with the lead lender</td>
<td></td>
</tr>
</tbody>
</table>
The accounting for each lender in a term loan syndicate can be different; one lender’s loan may be considered modified, while another’s may be considered extinguished. Similarly, under ASC 470-50-40-21, issuance costs may be written off for one member of a line-of-credit syndicate but not another.

If an exchange or modification offer is made to all members of a loan syndicate and only some of the lenders agree to the offer, the 10% test should be applied to the debt instruments held by the lenders that accept the offer. Debt instruments held by lenders that do not agree to the exchange or modification offer are not affected unless they are paid off, in which case they are extinguished.

If a new lender enters a loan syndicate and provides a new term loan or access to a new line of credit, it is considered a new arrangement and not a modification. Therefore, fees paid to that lender and allocated third-party costs should be accounted for in the same way as for a new loan or line of credit (i.e., deferred as debt issuance costs and amortized over the life of the new term loan or line of credit).

The modification of a loan syndication will typically be arranged by an investment bank; oftentimes, that investment bank is also a lender in the loan syndication. A reporting entity should assess whether fees paid to the investment bank arranging the restructuring are being paid for third-party services or as a lender fee. If the investment bank is being compensated to perform services that could be performed by a third party, the fee should generally be accounted for as a third-party cost.

Question 3-2 discusses the application of the 10% test when debt is replaced with new debt issued to a loan syndicate that includes some of the original lenders.

**Question 3-2**

A reporting entity issues debt to a loan syndicate, which includes two funds managed by FG Group, FG Fund 1 and FG Fund 2. The reporting entity later replaces this debt with new debt issued to a loan syndicate which includes FG Fund 1 and FG Fund 5, which is also managed by FG Group.

Should the reporting entity treat the funds as one lender or separate lenders for purposes of determining whether its debt has been modified or extinguished?

**PwC response**

It depends on how the funds are structured and managed. If FG Group’s funds are effectively operated as separate funds, they should be treated as such in the analysis. Conversely, if the funds are effectively operated as one fund, they should be treated as a single lender. For example, if the FG Funds are (1) separate legal entities, (2) not consolidated by FG Group, and (3) FG Group has a fiduciary responsibility to manage each fund for the best interest of the holders of each particular fund, then each FG Group fund should be treated as a separate lender for purposes of determining whether its debt has been modified or extinguished. The debt held by FG Fund 2 should be extinguished because it is not participating in the new loan syndication. The debt issued to FG Fund 5 should be accounted for as new debt because it did not hold debt in the original syndicate. The debt held by FG Fund 1 should be assessed under the guidance in ASC 470-50-40 to determine whether the transaction should be accounted for as a modification or an extinguishment.
3.6.1 Costs associated with the modification of multiple instruments held by multiple lenders

In practice, a reporting entity may modify non-revolving (i.e., term debt) and revolving-debt arrangements at the same time. When this occurs, the reporting entity should allocate the new lender fees and third-party costs to the individual instruments using a reasonable and rational approach. These new fees and costs should be first allocated to each instrument; then further allocated to each lender. Once this allocation is complete, the reporting entity should determine (1) whether the non-revolving debt has been modified or extinguished under the guidance in ASC 470-50-40, and (2) the appropriate accounting for the revolving-debt arrangement under the guidance in ASC 470-50-40-21.

Question 3-3 discusses how to determine whether a term loan has been modified or extinguished when it is replaced with a revolving-debt arrangement.

Question 3-3

A reporting entity has a $5,000,000 term loan that is prepayable without penalty. Two years prior to the maturity of the term loan, the reporting entity repays the term loan and concurrently enters into a revolving-debt arrangement with the same lender. The revolving-debt arrangement has a maximum amount available of $5,000,000 for five years. The reporting entity immediately draws $5,000,000 on the revolving-debt arrangement.

How should the reporting entity determine whether the term loan has been modified or extinguished for accounting purposes?

PwC response

Although there is no guidance on how to account for a term loan that is replaced with a revolving-debt arrangement, ASC 470-50-55-10 through ASC 470-50-55-13 discusses the accounting for a modification of a revolving-debt arrangement with a term loan. This guidance respects the initial form of the debt instrument and states that a modification of a revolving-debt arrangement with a term loan should be assessed under the revolving debt guidance in ASC 470-50-40-21. We believe it is appropriate to analogize to that guidance and respect the initial form of the debt instrument. Therefore, when a term loan is replaced with a revolving-debt arrangement, we believe the 10% test should be used to determine whether a term loan has been modified or extinguished for accounting purposes given the terms of the amount borrowed under the new revolving-debt arrangement.

Example 3-7 illustrates the accounting for a modification of a term loan syndication.

EXAMPLE 3-7

Modification of a term loan syndication

FG Corp has a term loan syndication. Its credit rating has improved and interest rates have declined since the original loan syndication was entered into, so FG Corp has decided to modify its loan syndication to lower its borrowing costs.

The existing loans in the loan syndication are prepayable at any time without penalty; therefore, the fees paid by FG Corp are related to the borrowing of additional funds. The terms of the original loan
Debt modification and extinguishment

syndication and the new loan syndication at the modification date are summarized in the following table.

<table>
<thead>
<tr>
<th></th>
<th>Original loan syndication</th>
<th>New loan syndication</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal balance</td>
<td>$52,000,000</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Annual coupon</td>
<td>5.5%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Original term</td>
<td>10 years</td>
<td>5 years</td>
</tr>
<tr>
<td>Remaining term</td>
<td>3 years</td>
<td>5 years</td>
</tr>
<tr>
<td>Unamortized debt issuance costs</td>
<td>$695,000</td>
<td>—</td>
</tr>
<tr>
<td>New lender fees</td>
<td>—</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>New third-party fees</td>
<td>—</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

The modification is not a TDR because FG Corp is not experiencing financial difficulties.

How should FG Corp account for the restructuring of its term loan syndication?

Analysis

FG Corp should perform the following analysis.

Compare lender balances

Lenders in the original and new loan syndications are compared to determine common lenders to both agreements. The principal balances of common lenders are classified as (1) original debt, (2) additional borrowing, or (3) pay-down.

The lender by lender balances in the original and new loan syndications, the change in each lender’s balance, and the classification of each lender’s principal balance are summarized in the following table.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Balance of original syndication</th>
<th>Balance of new syndication</th>
<th>Principal change</th>
<th>Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>—</td>
<td>Original debt</td>
</tr>
<tr>
<td>B</td>
<td>$20,000,000</td>
<td>$30,000,000</td>
<td>$10,000,000</td>
<td>Original debt and additional borrowing</td>
</tr>
<tr>
<td>C</td>
<td>—</td>
<td>$60,000,000</td>
<td>$60,000,000</td>
<td>Additional borrowing</td>
</tr>
<tr>
<td>D</td>
<td>$12,000,000</td>
<td>$5,000,000</td>
<td>($7,000,000)</td>
<td>Original debt and partial pay-down</td>
</tr>
</tbody>
</table>
Allocate new lender fees to each lender

Next, the new lender fees paid are allocated to the each lender in the syndicate. New fees paid to lenders are allocated to each bank in the new syndicated facility using a rational approach, which is determined to be pro-rata in this fact pattern. Because all of the loans are prepayable without penalty, none of the fees paid are associated with the pay-off amounts.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Balance of new syndication</th>
<th>Percentage of new syndication</th>
<th>Allocation of new lender fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$5,000,000</td>
<td>5.0%</td>
<td>$200,000</td>
</tr>
<tr>
<td>B</td>
<td>$30,000,000</td>
<td>30.0%</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>C</td>
<td>$60,000,000</td>
<td>60.0%</td>
<td>$2,400,000</td>
</tr>
<tr>
<td>D</td>
<td>$5,000,000</td>
<td>5.0%</td>
<td>$200,000</td>
</tr>
<tr>
<td>E</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$100,000,000</td>
<td>100.00%</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

Perform the 10% test

Using the information in the two tables above, FG Corp would perform the 10% test for the lenders that were in the facility before and after the restructuring; the results of the 10% test are summarized in the table below.

The new loan syndication is prepayable at any time without penalty; therefore, to determine the cash flows of the new loan syndication, FG Corp would assume prepayment at the modification date and calculate the new loan syndication cash flows as the sum of (1) the change in principal balance, (2) the new lender fees, and (3) the repayment of the “new” principal (i.e., assume the principal balance post modification is pre-paid).

See FG 3.4.5 for further information on changes in principal balance.
Debt modification and extinguishment

### New cash flow detail

<table>
<thead>
<tr>
<th>Bank</th>
<th>Original cash flows</th>
<th>Principal change</th>
<th>Lender fees</th>
<th>Repayment</th>
<th>Total new cash flows</th>
<th>Percent change</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>($5,000,000)</td>
<td>—</td>
<td>($200,000)</td>
<td>($5,000,000)</td>
<td>($5,200,000)</td>
<td>(4%)</td>
</tr>
<tr>
<td>B</td>
<td>($20,000,000)</td>
<td>$10,000,000</td>
<td>($1,200,000)</td>
<td>($30,000,000)</td>
<td>($21,200,000)</td>
<td>(6%)</td>
</tr>
<tr>
<td>D</td>
<td>($12,000,000)</td>
<td>($7,000,000)</td>
<td>($200,000)</td>
<td>($5,000,000)</td>
<td>($12,200,000)</td>
<td>(2%)</td>
</tr>
</tbody>
</table>

Because each change in cash flows is less than 10%, it is not necessary to perform the cash flow scenarios assuming no prepayment. The change in each lender’s loan balance should be accounted for as a modification.

### Account for unamortized costs

Unamortized debt issuances costs from the original syndicated facility are allocated to each bank on a pro-rata basis using the original syndication balances. The unamortized debt issuance costs associated with loans that are paid in full are expensed. The remaining unamortized debt issuance costs continue to be deferred.

The following table summarizes the allocation of unamortized issuance costs.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Balance of original syndication</th>
<th>Percentage of original syndication</th>
<th>Allocation of unamortized issuance costs</th>
<th>Accounting for unamortized issuance costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$5,000,000</td>
<td>9.6%</td>
<td>$66,827</td>
<td>Defer</td>
</tr>
<tr>
<td>B</td>
<td>$20,000,000</td>
<td>38.5%</td>
<td>$267,308</td>
<td>Defer</td>
</tr>
<tr>
<td>D</td>
<td>$12,000,000</td>
<td>23.1%</td>
<td>$160,385</td>
<td>Defer</td>
</tr>
<tr>
<td>E</td>
<td>$15,000,000</td>
<td>28.8%</td>
<td>$200,480</td>
<td>Expense</td>
</tr>
<tr>
<td>Total</td>
<td>$52,000,000</td>
<td>100.0%</td>
<td>$695,000</td>
<td></td>
</tr>
</tbody>
</table>

The amounts allocated to the loans that are fully paid off are written off pursuant to ASC 470-50-40-2. The amounts allocated to the original debt that remains outstanding continue to be deferred because the loans were modified for accounting purposes, rather than extinguished.

### Account for lender fees

As noted above, new fees paid to lenders were allocated to each bank in the new syndicated facility on a pro-rata basis and all of the fees paid are associated with either the remaining original debt or the additional borrowings. No amounts were allocated to the loans paid off. Therefore, all of the lender fees are capitalized in accordance with ASC 470-50-40-17 for the original loan and ASC 835-30-45-1A for the additional borrowings.
Account for third-party costs

New fees paid to third parties are allocated to each bank in the new syndicated facility using a rational approach. The third-party fees allocated to the new borrowing with Bank C should be deferred in accordance with ASC 835-30-45-3. The remaining third-party costs should be expensed in accordance with ASC 470-50-40-18.

The following table summarizes the allocation of the third-party fees.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Balance of new syndication</th>
<th>Percentage of new syndication</th>
<th>Allocation of new third-party fees</th>
<th>Accounting for new third-party fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$5,000,000</td>
<td>5.0%</td>
<td>$50,000</td>
<td>Expense</td>
</tr>
<tr>
<td>B</td>
<td>$30,000,000</td>
<td>30.0%</td>
<td>$300,000</td>
<td>Expense</td>
</tr>
<tr>
<td>C</td>
<td>$60,000,000</td>
<td>60.0%</td>
<td>$600,000</td>
<td>Defer</td>
</tr>
<tr>
<td>D</td>
<td>$5,000,000</td>
<td>5.0%</td>
<td>$50,000</td>
<td>Expense</td>
</tr>
<tr>
<td>E</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$100,000,000</td>
<td>100.00%</td>
<td>$1,000,000</td>
<td></td>
</tr>
</tbody>
</table>

3.7 Debt extinguishment accounting

ASC 405-20-40-1 provides guidance on when a reporting entity should derecognize a liability. This guidance does not apply to convertible debt with a cash conversion feature. See FG 6.6.5 for information on the derecognition (conversion or extinguishment) of such instruments.

Excerpt from ASC 405-20-40-1

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.
A reporting entity should also derecognize a debt instrument (and recognize a new one) when a debt modification or exchange is deemed an extinguishment. See FG 3.4 for information on modifications and exchanges of term loans and debt securities, and FG 3.6 for information on modifications and exchanges of loan syndications and participations.

ASC 470-50-55-9 provides guidance on situations that do not result in a debt extinguishment.

**ASC 470-50-55-9**

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.

An extinguishment should not be recognized prior to its occurrence; therefore, a debtor’s announcement of its intent to call its debt should not result in an extinguishment.

See FG 3.8 for information on debt defeasance.

**3.7.1 Measuring the gain or loss on debt extinguishment**

ASC 470-50-40-2 provides guidance on how to calculate a gain or loss on debt extinguishment.

**ASC 470-50-40-2**

A difference between the reacquisition price of the 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.

The ASC Master Glossary defines the reacquisition price of debt and the net carrying amount of debt.

**Definitions from ASC Master Glossary**

Reacquisition Price of Debt: The amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities.

Net Carrying Amount of Debt: Net carrying amount of debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.
The reacquisition price includes the fair value of any assets transferred or equity securities issued. It also includes fees (which may include noncash fees) the reporting entity pays the original lender in connection with the extinguishment. Typically, accrued interest payable is settled in cash upon extinguishment (i.e., the issuer pays the investor the accrued interest in cash). However, if accrued interest payable is not paid in cash upon extinguishment, it should be deducted from the reacquisition price (i.e., a portion of the reacquisition price should be treated as payment of interest). The net carrying amount of debt includes an unamortized premium, discount, and debt issuance costs.

If a reporting entity extinguishes a portion of a debt instrument (e.g., exercises an existing prepayment option), the unamortized premium, discount, and debt issuance costs associated with the portion extinguished should be expensed; the remaining unamortized debt issuance costs continue to be deferred. For example, if a reporting entity exercises an existing call option and repays 50% of the debt balance, the reporting entity has extinguished 50% of the debt and should expense 50% of the unamortized costs.

See FG 3.3.5 for information on the recognition of a debt extinguishment gain when a lender also holds equity securities of the reporting entity. Extinguishment losses are typically charged to earnings unless the loss is in substance a dividend (i.e., a pro-rata distribution to all equity holders).

See FSP 12.11.1 for information on the classification of a gain or loss on debt extinguishment.

Example 3-8 illustrates how the gain or loss on a debt extinguishment is measured.

**EXAMPLE 3-8**

**Calculating a gain or loss on debt extinguishment**

FG Corp reacquired its term loan for cash of $50,000,000. It paid $500,000 in fees to its lender in connection with the extinguishment.

The carrying amount of the debt at the date of reacquisition was $50,000,000, and FG Corp had unamortized debt issuance costs of $1,000,000. There is no unamortized debt discount or premium and no accrued interest payable associated with the debt.

What is FG Corp’s gain or loss on extinguishment of its debt?

**Analysis**

The reacquisition price is the carrying amount of the debt and the fees paid to the lender to extinguish the debt.
The gain or loss on extinguishment is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term loan carrying amount</td>
<td>$50,000,000</td>
</tr>
<tr>
<td>Less: unamortized debt issuance costs</td>
<td>(1,000,000)</td>
</tr>
<tr>
<td>Net carrying amount</td>
<td>49,000,000</td>
</tr>
<tr>
<td>Reacquisition price</td>
<td>50,500,000</td>
</tr>
<tr>
<td>Loss on extinguishment</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>

FG Corp should recognize a loss on extinguishment of $1,500,000 in net income.

### 3.7.2 Debt extinguishment as a subsequent event

An extinguishment occurring subsequent to the end of a fiscal period but prior to the issuance of the financial statements should be accounted for as a nonrecognized subsequent event, which is not recorded in the financial statements, but may require disclosure. See FSP 28 for information on subsequent events.

### 3.8 Debt defeasance

A borrower may enter into a defeasance, or refunding, arrangement with its lenders in an effort to derecognize its debt liability. A defeasance arrangement is generally a legal defeasance of the borrower’s liability to the lender, not a payment by the borrower to the lender. Defeasance arrangements may involve the borrower transferring an amount of cash or high-quality financial assets sufficient to service the debt obligation to maturity (or to an earlier call date) to an irrevocable trust. The trust undertakes the obligation to service the debt using the assets it has received.

To determine the appropriate accounting for a debt defeasance, a debtor should consider whether it has been legally released from being the primary obligor under the liability based on the guidance in ASC 405. If the arrangement involves the transfer of assets to a trust, it should determine whether it has surrendered control over the transferred financial assets based on the guidance in ASC 860-10-40-4, ASC 860-10-40-5 and ASC 860-10-40-6 and if it should consolidate the trust for financial reporting purposes (see CG 2 for information on consolidation of a trust).

When a lender releases a debtor as the primary obligor, it may require the debtor to become the secondary obligor (i.e., the debtor becomes a guarantor). Depending on the facts and circumstances, such an obligation could prevent derecognition of the liability. See FG 2 for information on the accounting for guarantees.

### 3.8.1 Legal defeasance versus in-substance defeasance

ASC 405-20-55-9 provides guidance on when a liability is extinguished by a debt defeasance.
Debt modification and extinguishment

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.

Whether a borrower has met the requirements for legal defeasance and consequently satisfied the condition for extinguishment accounting in ASC 405-20-40-1(b) is a matter of law. The best form of evidence to provide reasonable assurance that criterion ASC 405-20-40-1(b) has been satisfied is a legal opinion.

In an in-substance defeasance, the debtor transfers cash or high-credit quality assets to an irrevocable trust established for the benefit of the lender. The cash flows from the assets are used to pay the scheduled interest and principal payments on the debt; however, the lender does not release the debtor as the primary obligor for the debt. ASC 405-20-55-4 provides guidance on an in-substance defeasance.

Excerpt from ASC 405-20-55-4

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.

3.8.2 Transfer of non-cash financial assets to a defeasance trust

When a debtor transfers non-cash financial assets (i.e., treasury or other governmental securities) to a defeasance trust, it should evaluate the criteria in ASC 860-10-40-4 through ASC 860-10-40-6 to determine whether it has surrendered control over the transferred assets. Under that guidance, if the
transferred assets have been legally isolated from the debtor (e.g., put presumptively beyond the reach of the debtor and its lenders, even in bankruptcy), then the debtor has surrendered control over the transferred assets, and the trust has obtained control of them. The isolation criterion is primarily a legal determination; a legal opinion is needed to evaluate satisfaction of this criterion. See TS2 for information on control criteria for transfers of financial assets.

If any of the criteria in ASC 860-10-40-4 through ASC 860-10-40-6 are not met, the debtor should not derecognize the transferred financial assets or the debt. Additionally, the debtor should evaluate whether it is required to consolidate the trust.

3.8.3 Transfer of cash to a defeasance trust

In conjunction with a defeasance arrangement, a debtor may transfer cash to a defeasance trust so that the trust can purchase risk-free investments (i.e., treasury or other governmental securities) to provide cash flows corresponding to the debt service requirements. A transfer of cash is not within the scope of ASC 860-10-40-4 through ASC 860-10-40-6. Nevertheless, the debtor should evaluate its continuing involvement with the trust (or its assets) to determine whether it has relinquished control over the assets in the trust. If the debtor has control of the trust or its assets, it may raise the question of whether the trust’s assets would be drawn into the debtor’s bankruptcy proceeding. A legal opinion similar in form to an evaluation under ASC 860-10-40-4 through ASC 860-10-40-5 may be required to conclude that the transferred cash has been put presumptively beyond the reach of the debtor and its lenders, even in bankruptcy.

The form and extent of the continuing involvement is a matter of judgment that depends on the relevant facts and circumstances. The indicators listed below should be considered in that evaluation; however, no one indicator should be considered presumptive or determinative. The relative consequence of each indicator or combination of indicators should be considered.

- The debtor maintains a residual interest in the assets of the trust
- The debtor may instruct the trustee to sell trust assets and purchase other assets
- The trust may seek investment advice from the debtor
- The trustee may apply at any time to the debtor for instructions, and may consult with counsel for the debtor as to matters arising in connection with its servicing of the trust
- The debtor is a secondary obligor to the liability assumed by the trust

If the debtor has a significant level of continuing involvement, and is not able to obtain a legal opinion concluding that the transferred cash has been put presumptively beyond the reach of the debtor and its lenders, even in bankruptcy, the debt should not be extinguished. Additionally, the level of continuing involvement may cause the debtor to have to consolidate the trust for financial reporting purposes.
Chapter 4: Common stock and dividends
4.1 **Chapter overview**

This chapter discusses the accounting considerations related to the issuance of common stock and other transactions with shareholders, such as advances to shareholders. It also discusses the accounting treatment of dividends and stock splits.

See FG 7 for information on preferred stock and the accounting for equity issuance costs. See FG 9 for information on share repurchases and treasury stock.

4.2 **Characteristics of common stock**

Common stock is the most subordinate class of shares of a reporting entity. The common shareholders generally profit the most when a reporting entity is successful and bear the greatest risk of loss when a reporting entity fails. Figure 4-1 summarizes some of the characteristics of common stock.

**Figure 4-1**
Characteristics of common stock

<table>
<thead>
<tr>
<th>Feature</th>
<th>Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidation preference</td>
<td>In the event of liquidation, common shareholders have an unsecured interest over the reporting entity's residual net assets after satisfaction of all other claims and preferences and bear the ultimate risk of loss</td>
</tr>
<tr>
<td>Dividends</td>
<td>Dividends paid to common shareholders may vary from period to period and typically are not guaranteed</td>
</tr>
<tr>
<td>Voting</td>
<td>Typically, common shareholders control the voting power of a reporting entity</td>
</tr>
<tr>
<td>Term</td>
<td>Common stock typically has no redemption date</td>
</tr>
<tr>
<td>Par value</td>
<td>Most common stock has either no or minimal par value</td>
</tr>
</tbody>
</table>

In every corporation, one class of stock represents the basic ownership interest; that class is called common stock. However, in an effort to broaden investor appeal, corporations may offer two or more classes of stock, each with different rights or privileges. Common stock can be issued in a variety of ways, including through an original capital infusion, an initial public offering, issuance of stock-based compensation, settlement of equity-linked instruments, and stock dividends.

4.3 **Accounting for the issuance of common stock**

Common stock should be recognized on its settlement date (i.e., the date the proceeds are received and the shares are issued). Upon issuance, common stock is generally recorded at its fair value, which is typically the amount of proceeds received. Those proceeds are allocated first to the par value of the shares, with any excess over par value allocated to additional paid-in capital.
If common stock is sold using an escrow arrangement in which cash is deposited in an escrow account for the purchase of the shares, the issuer should determine who owns the escrow account in the event of the investor’s bankruptcy. If the investor’s creditors have access to the escrowed cash in the event of the investor’s bankruptcy, the cash held in escrow should not be recorded on the issuer’s balance sheet and the common stock should not be recorded until the escrowed cash is legally transferred to the issuer and the shares are delivered to the investor.

Common stock may be sold for future delivery through a forward sale contract. In a forward sale contract, the investor is obligated to buy (and the reporting entity is obligated to sell) a specified number of the reporting entity’s shares at a specified date and price. See FG 8.2.1 for information on forward sales of a reporting entity’s own equity securities.

When common stock is sold in a bundled transaction with other securities or instruments, such as preferred stock or warrants, the proceeds should be allocated between the common stock and other instruments issued. How the proceeds are allocated depends on the accounting classification (i.e., liability or equity) of the other instruments. See FG 8.3.1 for information on warrants issued with common stock.

If separate classes of securities, which each meet the requirements for equity classification (such as preferred or common stock), are issued together in a single transaction, the issuance proceeds should be allocated to each class based upon their relative fair values. The fair value of each class of equity securities may be different than the amounts stipulated in the purchase agreement. When multiple investors are involved, the allocation of proceeds should be performed on an investor-by-investor basis.

When a reporting entity receives a note rather than cash or other assets in exchange for issuing common stock, the note should generally be classified as a contra-equity account, which offsets the increase in equity from the issuance of the shares. See FG 4.5.1 for additional information.

### 4.3.1 Estimating the fair value of common stock

When common shares are not traded (or, in the case of bundled issuances of common and preferred shares, are not traded separately) in an active market, it can be difficult to determine their fair value. Nevertheless, US GAAP provides no relief from the requirement to determine fair value in those circumstances. When estimating the fair value of common stock, an issuer should follow the guidance in ASC 820, *Fair Value Measurement*. See FV 4 for information on determining the fair value of equity securities.

In addition, a reporting entity should consider the SEC staff’s views on “cheap stock.” Cheap stock broadly refers to equity instruments, such as common stock, stock options, or equity classified warrants, that are issued shortly before an initial public offering date, at prices significantly below the initial public offering price. See SC 3.5 for further information.

### 4.3.2 Market value guarantee of common stock

A reporting entity may enter into an arrangement with a shareholder under which it guarantees a minimum price for its common stock. Such a guarantee protects the shareholder from declines in the value of the reporting entity’s common stock. The terms of the guarantee may require the reporting entity to repurchase the shares from the shareholder in exchange for cash (i.e., the shares become
puttable) or may require the shareholder to sell the shares in the open market and have the reporting entity pay the difference between the sales price and the guaranteed price.

When a market value guarantee is embedded in the common shares (i.e., the shares can be put to the reporting entity) the shares should be recorded in mezzanine equity. See FG 7.3.4 for further information on mezzanine equity classification. If instead, a market value guarantee requires the shareholder to sell its shares in the open market and the reporting entity pays the difference between the sales price and the guaranteed price, the market value guarantee may be a written put option which should be recorded as a liability based on the guidance in ASC 480, Distinguishing Liabilities from Equity. See FG 9.2.5 for information on written put options on a reporting entity’s own shares.

4.4 Dividends

A dividend is a payment, either in cash, other assets (in kind), or stock, from a reporting entity to its shareholders. Figure 4-2 provides definitions for some of the terms used in connection with dividends.

**Figure 4-2**
Terms used in connection with dividends

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consent dividend</td>
<td>Retained earnings of a personal holding company, which, although not distributed to shareholders, are reported by the shareholders for federal income tax purposes as an ordinary dividend. The tax basis of the stock is increased by the amount of the consent dividend</td>
</tr>
<tr>
<td>Constructive dividend</td>
<td>Distribution to shareholders without a formal dividend declaration by the board of directors</td>
</tr>
<tr>
<td>Cumulative dividend</td>
<td>Preferred dividend that must be declared and paid for all periods, before any dividend may be declared and paid to common shareholders</td>
</tr>
<tr>
<td>Deemed dividend</td>
<td>A transaction that does not necessarily have the characteristics generally associated with a dividend, but nevertheless results in a transfer of value to the holder of an equity instrument that requires accounting similar to a dividend (e.g., a beneficial conversion feature in convertible preferred stock)</td>
</tr>
<tr>
<td>Dividend arrearage</td>
<td>Cumulative preferred dividends for prior periods not declared or paid</td>
</tr>
<tr>
<td>Dividend equivalents</td>
<td>Amounts paid to holders of unissued shares (e.g., unvested stock or options) in a stock compensation plan</td>
</tr>
<tr>
<td>Dividend in kind</td>
<td>Dividend paid by distributing property (including notes) of the reporting entity rather than cash</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>-----------------------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Ex-dividend</td>
<td>Term indicating that the quoted price of a share of stock excludes the value of a declared dividend; the term attaches from the record date, or a few days before the record date (to allow for the recording of transfers just prior to the record date), until the payment date</td>
</tr>
<tr>
<td>Extraordinary (special) dividend</td>
<td>Dividend in addition to the usual periodic dividend</td>
</tr>
<tr>
<td>Liquidating dividend</td>
<td>Distribution to shareholders in excess of earnings, representing a return of capital</td>
</tr>
<tr>
<td>Nimble dividend</td>
<td>Dividend declared from current year earnings despite an accumulated deficit from past operations</td>
</tr>
<tr>
<td>Noncumulative dividend</td>
<td>Preferred dividend to which the preferred shareholders lose their rights if the dividend is not declared in respect of the applicable period</td>
</tr>
<tr>
<td>Nonparticipating dividend</td>
<td>Preferred dividend that never exceeds a specified rate regardless of the dividends paid to common shareholders</td>
</tr>
<tr>
<td>Optional dividend</td>
<td>A dividend for which shareholders may choose to receive cash or shares</td>
</tr>
<tr>
<td>Ordinary dividend</td>
<td>Pro rata distribution to shareholders of cash, other assets (including evidences of indebtedness), or shares of capital stock declared by the board of directors</td>
</tr>
<tr>
<td>Paid-in-kind (PIK) dividend</td>
<td>Dividend paid in the form of additional shares of stock having a value equal to the specified dividend rate</td>
</tr>
<tr>
<td>Participating dividend</td>
<td>Preferred dividend in excess of a stipulated minimum rate, shared with the common shareholders (the preferred shareholders participate in the earnings of the entity) usually after the dividends paid to the common shareholders reach a prescribed amount per share. Fully participating dividends are shared, after the prescribed minimums, without limitation; partially participating dividends are shared only to a specified maximum amount per share</td>
</tr>
<tr>
<td>Preferred dividend</td>
<td>Dividend on preferred stock usually at a specified rate stated in dollars per share or as a percentage of par value, payable at stated intervals, usually quarterly</td>
</tr>
<tr>
<td>Record date</td>
<td>Date at which shareholders registered in the stock records will share in the dividend payment. This date is usually between the declaration date and payment date</td>
</tr>
<tr>
<td>Scrip dividend</td>
<td>A dividend paid in the form of promissory notes that may be negotiable, bear interest, and mature at different dates, and that is usually payable in cash</td>
</tr>
</tbody>
</table>
### Term | Definition
--- | ---
Spinoff | Pro rata distribution by a reporting entity of shares of a subsidiary without the surrender of the shares in the distributing reporting entity
Splitoff | Distribution by a reporting entity of shares of a subsidiary in exchange for a portion of the shares in the distributing reporting entity
Splitup | Distribution by a reporting entity of shares of a subsidiary and new shares of its own stock in exchange for all of the old shares of the distributing reporting entity
Stock dividend | Dividend payable in shares of the reporting entity’s own stock
Stock split | Issuance of additional shares of stock at a fixed ratio in relation to current shares to present shareholders. See FG 4.4.4 for information on the distinction between stock dividends and stock splits
Record date | Date at which shareholders registered in the stock records will share in the dividend payment. This date is usually between the declaration date and payment date

See BCG 8 for information on accounting for spinoffs and splitoffs.

#### 4.4.1 Declaring a dividend

Generally, a reporting entity’s board of directors decides when, in what amount, and in what form of consideration dividends are to be paid. When making decisions about a dividend payment, the board considers a number of factors, including the following.

- The legality of the dividend in relation to the reporting entity’s articles of incorporation and relevant state (or other jurisdiction) law
- Regulatory restrictions regarding dividend payments
- The reporting entity’s financial position, including current and retained earnings and liquidity
- Future plans of the reporting entity
- Tax consequences
- General business conditions
- Long-term dividend policy, including planned return to the shareholders

Statutory restrictions may limit the timing and amount of dividends that can be declared to shareholders. Typically, a reporting entity is subject to the laws of the state in which it is incorporated. The diversity of dividend statutes across jurisdictions makes it impracticable to state a general rule on the amounts available for dividends. However, a common restriction is that dividends may not be paid...
if doing so would render the reporting entity insolvent. For solvent reporting entities, payment of dividends from retained earnings is almost always permissible. In the US, state law typically governs corporate activities, including the payment of dividends. Some states allow dividends to be paid from current earnings despite an accumulated deficit from past operations; these are sometimes referred to as nimble dividends. In some circumstances, dividends may be paid from capital surplus or an appraisal surplus. Outside the US, dividend restrictions may be more onerous and, in many cases, may also require shareholder approval before they can be declared and paid.

4.4.2 **Recording a dividend**

A dividend should be recorded when it is declared and notice has been given to the shareholders, regardless of the date of record or date of settlement. As a practical matter, the dividend amount is not determinable until the record date. To record a dividend, a reporting entity should debit retained earnings (or any other appropriate capital account from which the dividend will be paid) and credit dividends payable on the declaration date.

4.4.3 **Dividend in kind**

A dividend in kind is paid by distributing property of the reporting entity, so is considered a nonmonetary transaction. As such, it should be recorded using the guidance in ASC 845, *Nonmonetary Transactions*. As discussed in ASC 845-10-30-10, when a reporting entity distributes its property (other than investments in an entity it controls) in a pro rata dividend to all shareholders, the amount of the dividend is equal to the fair value of the property distributed.

If a reporting entity distributes shares of a consolidated entity or equity method investee as a dividend, it should be valued based on the recorded amount of the nonmonetary assets distributed based on the guidance in ASC 845-10-30-10.

**ASC 845-10-30-10**

Accounting for the distribution of nonmonetary assets to owners of an entity in a spinoff or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination shall be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) (see paragraph 360-10-40-4) of the nonmonetary assets distributed... A pro rata distribution to owners of an entity of shares of a subsidiary or other investee entity that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spinoff. Other nonreciprocal transfers of nonmonetary assets to owners shall be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

If part of the shares of an investee accounted for under the equity method are distributed as a dividend in kind and part are concurrently sold by the investor on the open market, accounting for the dividend in kind at the recorded amount may not be appropriate.

4.4.4 **Stock dividends and stock splits**

A stock dividend is a dividend paid in shares, generally issued to provide common shareholders with a portion of their respective interest in retained earnings without distributing cash from the business. A
stock split is the issuance of common shares to existing shareholders for the purpose of reducing the per share market price. Lowering the per share price increases their marketability to a wider population of investors without diluting the ownership interests of the existing common shareholders.

In both a stock dividend and a stock split, a reporting entity issues shares to its existing shareholders in proportion to their ownership interest. Generally, a stock dividend is a smaller distribution than a stock split, but whether an issuance of shares is a stock dividend or stock split is not always clear. Both the AICPA and the New York Stock Exchange (NYSE) have indicated that when an issuance of shares is so small in comparison with the shares previously outstanding that it has no apparent effect upon the market price, there is a presumption that a stock dividend was declared. Similarly, when the number of additional shares issued is so great that it has, or may reasonably be expected to have, the effect of materially reducing the share price, the transaction should be treated as a stock split.

ASC 505-20-25-3, ASC 505-20-25-4, ASC 505-20-25-5, and ASC 505-20-25-6 and the NYSE have established rules of thumb as to what constitutes a “small” distribution that should be treated as a stock dividend and a “large” distribution that should be treated as a stock split. The SEC’s interpretation in this area is discussed in SEC FRP 214, *Pro Rata Stock Distributions to Shareholders*. Figure 4-3 summarizes this guidance.

**Figure 4-3**  
Differentiating between a stock dividend and a stock split

<table>
<thead>
<tr>
<th></th>
<th>ASC 505-20-25-3 through ASC 505-20-25-6</th>
<th>NYSE manual section 703.02A</th>
<th>SEC FRP 214</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stock dividend</strong></td>
<td>Less than 20-25% of the number of shares outstanding prior to the distribution</td>
<td>Less than 25% of the number of shares outstanding prior to the distribution</td>
<td>Less than 25% of shares of the same class outstanding</td>
</tr>
<tr>
<td><strong>Stock split</strong></td>
<td>Greater than 20-25% of the number of shares outstanding prior to the distribution</td>
<td>Equal to or greater than 100% of the number of shares outstanding prior to the distribution</td>
<td></td>
</tr>
<tr>
<td><strong>Additional information</strong></td>
<td>Distributions of new shares that are less than 20-25% of those previously outstanding or that recur frequently are to be treated as stock dividends even if management representations to shareholders that it is a stock split</td>
<td>Distributions greater than 25% but less than 100% of the number of shares outstanding prior to the distribution are treated as a stock dividend when the distributions assume the character of stock dividends through repetition under circumstances not consistent with the true intent and purpose of a stock split</td>
<td>Distributions of over 25% may be accounted for as a stock dividend if they are part of a program of recurring distributions and accounting for them as a stock split would be misleading</td>
</tr>
</tbody>
</table>
Although ASC 505-20-25 uses a different threshold than the NYSE, a reporting entity listed on the NYSE would generally treat a distribution of greater than 25% of the shares outstanding as a stock split.

When a stock dividend in form is determined to be a split in substance, ASC 505-20-50-1 recommends that every effort be made to avoid the use of the word dividend in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannot be done, the transaction be described, for example, as a split effected in the form of a dividend.

ASC 260-10-55-12 requires that computations of earnings per share give retroactive recognition to a change in capital structure occurring during the period (or after the close of the period but before the financial statements are available to be issued) for all periods presented. See FSP 5.12 for balance sheet reporting and FSP 7.6.1 for earnings per share considerations related to stock dividends and stock splits.

### 4.4.4.1 Accounting for a stock dividend

A stock dividend is recorded by transferring the fair value of the shares issued from retained earnings to the related equity accounts as discussed in ASC 505-20-30-3. Retained earnings is charged (debited) for the fair value of the shares, and capital stock (for the par value of the shares) and additional paid-in capital are credited. In those rare instances when the par value of the shares exceeds the fair value of the shares distributed, retained earnings should still be charged for the fair value of the shares, capital stock is credited for the par value of the stock, and additional paid-in capital is charged (debited) for the difference between fair value and par value. If there is no or insufficient paid-in capital, or if the directors vote to charge retained earnings for par value despite the existence of additional paid-in capital, it is acceptable to charge retained earnings.

In the case of stock dividends declared by closely held reporting entities, ASC 505-20-30-5 states that there is no need to capitalize retained earnings other than to meet legal requirements. The reason for this exception to the general rule is that it is presumed that, because of their intimate knowledge of the reporting entity’s affairs, shareholders understand the amount of available earnings for dividends. What constitutes a closely held reporting entity for this purpose depends on the circumstances in each case.

Issuance costs incurred in connection with stock dividends should be expensed as incurred. This differs from issuance costs incurred for sales of stock, which are typically recorded as a reduction of the sales proceeds.

Example 4-1 illustrates the accounting for a stock dividend.

**EXAMPLE 4-1**

**Accounting for a stock dividend**

FG Corp has 1 million common shares outstanding. The shares have a $1 par value per share. FG Corp declares a 10% stock dividend and, as a result, issues 100,000 additional shares to current stockholders. FG Corp’s common stock price is $5 per share on the declaration date.

How should FG Corp record the stock dividend?
Analysis

Upon declaration of the stock dividend, FG Corp should record the following journal entry.

<table>
<thead>
<tr>
<th>Dr. Retained earnings</th>
<th>$500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Common stock – par value</td>
<td>$100,000</td>
</tr>
<tr>
<td>Cr. Additional paid-in capital</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

Optional dividends

A reporting entity may issue a dividend to its shareholders and give the shareholders the choice of receiving the dividend in either cash or shares (referred to as an optional dividend). Consistent with the accounting for stock dividends, retained earnings should be charged for an amount equal to the fair value of the shares distributed. When shareholders have the option to elect cash or stock, the number of shares to be issued is a variable number. The amount of retained earnings capitalized for the entire distribution should be equal to the amount of the dividend had it been paid entirely in cash. It is rare that the fair value of the stock dividend would be less than the cash dividend; therefore, the cash dividend should be indicative of the minimum fair value of the shares issued.

Stock dividends when the reporting entity has an accumulated deficit

There is no specific guidance on the accounting for a stock dividend when a reporting entity has an accumulated deficit rather than retained earnings. The SEC staff has historically taken the view that in this circumstance, the reporting entity should capitalize only the stock’s par value from additional paid-in capital.

If a common stock dividend is paid to holders of preferred stock when there is an accumulated deficit, the dividend should be accounted for at fair value with a corresponding increase in loss applicable to common shareholders. Fair value accounting is also appropriate for dividends declared on preferred stock that are payable in the form of additional preferred shares. We believe the fair value charge for stock dividends declared on preferred stock should be recorded as a charge to additional paid-in capital when a retained earnings deficit exists by analogy to SAB Topic 3-C, Redeemable Preferred Stock. That guidance indicates that amortization of a discount to the redemption amount of preferred stock should be charged to additional paid-in capital in the absence of retained earnings.

Fractional shares

Stock dividends almost always create fractional shares. A reporting entity may address this by selling the fractional shares and distributing cash to shareholders, by issuing special certificates (called a scrip issue) for the fractional shares which are then bought and sold through an agent, by arranging for shareholders to buy or sell fractional shares without a scrip issue, or by issuing fractional share certificates.

Each method of handling fractional shares is accounted for in the same manner as whole shares issued as a stock dividend.

See FSP 5.10.4.2 for information on presentation considerations for fractional shares.
**Common stock and dividends**

*Stock dividends issued to a parent from a subsidiary*

Stock dividends issued from a subsidiary to its parent normally result in a memorandum entry by the parent for the additional shares received. Although the subsidiary may capitalize retained earnings in connection with the stock dividend, ASC 810-10-45-9 states that consolidated retained earnings need not be capitalized.

**4.4.4.2 Accounting for a stock split**

When a stock split is effected without a change in the par value of the shares, the reporting entity should charge either additional paid-in capital or retained earnings, depending on the directive of the board of directors and legal requirements, and record an offsetting credit to par value for the newly issued shares.

When the par value is changed to reflect the stock split, no entry is required; however, the number of outstanding shares should be increased to reflect the split.

Example 4-2 illustrates the effect of a stock split with a change in par value and Example 4-3 illustrates the effect of a stock split with no change in par value.

**EXAMPLE 4-2**

**Stock split – change in par value**

FG Corp has 1 million common shares outstanding. The shares have a $1 par value per share. FG Corp effects a 2 for 1 stock split and changes the par value to $0.50 to reflect the split. FG Corp’s shareholders’ equity section before the split is shown below.

<table>
<thead>
<tr>
<th>Before the stock split</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock (10 million shares authorized, 1 million shares issued and outstanding, par value $1)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

How should FG Corp account for the stock split?

*Analysis*

FG Corp should not record an entry to record the stock split. However, the details of common stock as presented in its shareholders’ equity section should be adjusted as shown below.

<table>
<thead>
<tr>
<th>After the stock split</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock (10 million shares authorized, 2 million shares issued and outstanding, par value $0.50)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>
EXAMPLE 4-3
Stock split – no change in par value

FG Corp has 1 million common shares outstanding. The shares have a $1 par value per share. FG Corp effects a 2 for 1 stock split and does not change the par value. FG Corp’s shareholders’ equity section before the split is shown below.

<table>
<thead>
<tr>
<th>Before the stock split</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock (10 million shares authorized, 1 million shares issued and outstanding, par value $1)</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
</tr>
</tbody>
</table>

How should FG Corp account for the stock split?

Analysis

FG Corp should record the following entry to transfer additional paid-in capital to the par value of common stock.

Dr. Additional paid-in capital $1,000,000
Cr. Common stock – par value $1,000,000

Reverse stock split

In a reverse stock split the reporting entity merges its outstanding shares to reduce the total number of shares outstanding and increase the per share stock price.

When a reverse stock split is effected without a change in the par value of the shares, the reporting entity should record an entry to reduce the common stock and increase additional paid-in capital. As with ordinary stock splits, no journal entry is required if the par value will change, although the description of common stock in the equity section should be updated.

4.5 Other transactions with shareholders

The following sections discuss notes received for common stock, advances to shareholders, and distributions of shares in settlement of litigation. See FG 8.4 for information on shareholder rights plans.

4.5.1 Notes received for common stock

When a reporting entity receives a note, rather than cash or other assets, in exchange for common shares or as a contribution to paid-in capital, the note should generally be recognized in equity as an offset to the shares issued. As discussed in ASC 505-10-45-2, recording the note as an asset is not
appropriate except in very limited circumstances in which there is substantial evidence of an intent and ability to pay the note in a reasonably short period of time.

As discussed in ASC 310-10-S99-2, the SEC staff believes public companies should record notes received in exchange for common stock as contra-equity (rather than an asset) unless the note is paid prior to the issuance of the financial statements. For private companies, in addition to a stated maturity occurring within a short time period, notes secured by irrevocable letters of credit or other liquid collateral can evidence an intent and ability to pay a note in a reasonably short period.

See FSP 5.9.1 for information on the presentation of notes received for common stock.

4.5.2 Advances to, and receivables from, shareholders

For public companies, ASC 310-10-S99-3 requires that notes or other receivables from a parent or another affiliate be recorded as contra-equity. The SEC staff indicated that 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, but by the relationship of the parties and the control inherent in that relationship. Although ASC 310-10-S99-3 discusses this guidance in the context of a partnership, we believe this guidance is applicable to other types of public companies as well.

4.5.2.1 Guidance for private companies

There is no authoritative guidance that deals directly with advances to, and receivables from, shareholders of private companies. In the absence of specific guidance, we believe the decision to reflect an advance to, or receivable from, a shareholder as an asset or, alternatively, as a reduction of shareholders’ equity, is dependent upon the specific facts of each situation. Generally, advances to, or receivables from, shareholders should be recognized as a reduction of equity. However, there may be some circumstances in which it is acceptable to classify the advance or receivable as an asset. A reporting entity should consider the following factors when determining the appropriate classification.

- The nature of the advance and the circumstances giving rise to the transaction
  
  In general, asset classification is only appropriate when an advance to, or receivable from, a shareholder is short-term and results from the normal course of business.

- Whether the receivable has fixed repayment terms and whether it is interest-bearing or collateralized

- The frequency of such advances and prior repayment histories

Question 4-1 discusses how a reporting entity should classify equal advances made to shareholders.

**Question 4-1**

Five shareholders each own 20% of a reporting entity. All five shareholders receive advances in the same amount with no interest or repayment terms. How should the reporting entity classify the advances?
**PwC response**
The reporting entity should account for the advances as a dividend because they are made to all shareholders and do not provide for repayment or the payment of interest.

If, on the other hand, not all of the shareholders received advances, the reporting entity would account for the advances as a reduction of shareholders’ equity.

Question 4-2 discusses how a subsidiary should classify periodic advances to its parent when the parent has no means to repay the subsidiary.

**Question 4-2**
The parent receives periodic advances from a subsidiary to fund its debt service and has no means to repay the subsidiary. How should the subsidiary classify the advances to its parent in its separate financial statements?

**PwC response**
The subsidiary should classify the advances to its parent as a reduction of shareholder’s equity or a dividend, not as an asset, in its separate financial statements.

Question 4-3 discusses how subsidiaries classify advances to their parent when the parent historically repaid the advances.

**Question 4-3**
A corporate conglomerate with numerous operating subsidiaries obtains advances from its subsidiaries as an alternative to bank financing. Historically, the parent has repaid the advances. How should the subsidiaries classify the advances to their parent in their separate financial statements?

**PwC response**
If the historical and current operations support the parent’s ability and intent to repay the advances, the subsidiaries may classify the advances to their parent as assets in their separate financial statements.

Question 4-4 discusses how a subsidiary should classify receivables from its parent when the subsidiary sells substantially all of its manufactured goods to the parent and recoverability of intercompany receivables has not historically been an issue.

**Question 4-4**
A subsidiary sells substantially all of its manufactured goods to its parent. Intercompany receivables are settled periodically and historically, recoverability has not been an issue. How should the subsidiary classify the receivable from its parent in its separate financial statements?

**PwC response**
The subsidiary may classify the receivables from its parent as an asset in its separate financial statements.
Question 4-5 discusses how a reporting entity should classify advances made to a shareholder who has failed to repay advances in the past.

**Question 4-5**

A reporting entity makes an advance to a shareholder to whom it has a history of making advances. The shareholder has failed to repay advances in the past and the reporting entity has forgiven the indebtedness. How should the reporting entity classify the advance?

**PwC response**

The reporting entity should account for the advance as a reduction of shareholders’ equity because the reporting entity’s history with the shareholder leaves repayment of the advance in doubt.

Regardless of whether the advance to or receivable from the shareholder is recorded as an asset or in equity, a reporting entity should consider the disclosure requirements of ASC 850, *Related Party Disclosures*. See FSP 26 for information on disclosure of related party transactions.

**4.5.2.2 Accounting for interest on shareholder loans**

There is no specific guidance on the accounting for interest on shareholder loans. We believe a reporting entity may either recognize the interest as a capital contribution upon receipt, or accrue interest income as earned. We believe recognizing a capital contribution as interest is received is generally the more appropriate treatment unless the note receivable is classified as an asset; in that case, accruing interest income when it is earned would be appropriate.

**4.5.3 Stock issued to shareholders in settlement of litigation**

A pro rata distribution of stock to all current shareholders in connection with a litigation settlement can be accounted for as either a stock dividend or stock split rather than as an expense associated with the litigation settlement. If, however, the stock is distributed only to shareholders of record during the class action period (class action shareholders), the fair value of the shares distributed should be expensed as a litigation settlement. Similarly, if all current shareholders receive a pro rata distribution and the class action shareholders receive an additional distribution, the fair value of the additional shares distributed to class action shareholders should be expensed as a litigation settlement. The shares distributed on a pro rata basis to all current shareholders may be treated as a stock dividend or stock split.
Chapter 5: 
Equity-linked instruments model
5.1 Chapter overview

A reporting entity may issue an equity-linked instrument to issue shares, repurchase shares or raise financing at a reduced rate. Debt with detachable warrants, convertible debt, and convertible preferred stock are all examples of equity-linked financings. Investors in an equity-linked financing typically receive a lower cash coupon or dividend to compensate the issuer for selling an option on its equity.

Due to their complexity, understanding equity-linked instruments requires a detailed analysis of the terms of each instrument issued, any related instruments, the underwriting agreement, and other relevant agreements.

This chapter discusses each of the steps and important points to consider when determining whether an equity-linked instrument should be accounted for in its entirety as equity or a liability (or asset), or separated into components.

5.2 Analysis of an equity-linked instrument

The analysis to determine the appropriate accounting for an equity-linked instrument is best performed using a multi-step approach. Figure 5-1 illustrates the overall model. The analyses described in this chapter are applicable to freestanding instruments and embedded components in host instruments that a reporting entity has not elected (or cannot elect) to carry at fair value.

Figure 5-1
Analysis of an equity-linked instrument

---

1 Note that hybrid instruments containing embedded equity-linked components should be analyzed to determine whether the entire hybrid instrument is within the scope of ASC 480.
5.3 Determining whether an instrument is freestanding or embedded

An equity-linked component can be embedded in a host instrument, such as a debt (e.g., convertible debt) or preferred stock (e.g., convertible preferred stock), that has economic value other than the equity-linked component. Alternatively, an instrument can comprise only the equity-linked component, as is the case with a freestanding warrant. The term “freestanding” also applies to a single financial instrument that comprises more than one option or forward component; for example, a collar, which consists of a written put option and a purchased call option.

ASC 480, Distinguishing Liabilities from Equity, applies to an issuer’s classification and measurement of certain freestanding financial instruments. Thus, the first step in determining the accounting for an equity-linked instrument is to determine whether the equity-linked feature is freestanding or embedded in a host instrument. See FG 5.5 for further information on the application of ASC 480.

The ASC Master Glossary provides a definition of a freestanding financial instrument.

**Definition from ASC Master Glossary**

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.

In determining whether an equity-linked component is a freestanding financial instrument or embedded in a host instrument, a reporting entity should consider all substantive terms.

A reporting entity should first determine whether the components are issued (1) contemporaneously and in contemplation of each other or (2) separately and at different points in time.

Next, a reporting entity should consider whether the components (1) may be legally transferred separately, or (2) must be transferred with the instrument with which they were issued or associated. Components that may be legally transferred separately are generally freestanding. However, a component that must be transferred with the instrument with which it was issued or associated is not necessarily embedded; it may merely be attached.

A reporting entity should also consider whether (1) a right in a component may be exercised separately from other components that remain outstanding or (2) if, once a right in a component is exercised, the other components are no longer outstanding. Since separate exercisability invariably requires the component to first be detached prior to exercise, this is a strong indicator that the components are freestanding.

Example 5-1 illustrates an evaluation of whether an equity-linked component is a freestanding financial instrument or embedded in a host contract.
EXAMPLE 5-1

Tranched preferred stock

FG Corp issues Series A preferred shares to investors. FG Corp grants investors in the Series A preferred shares a warrant to buy Series B preferred shares, if issued, at a fixed price (Series B warrant). The Series B preferred shares will only be issued (and the warrant is only exercisable) upon the receipt of a patent for a specified technology being developed by FG Corp.

The investors can transfer the Series B warrant separate from the Series A shares (i.e., they can sell the Series B warrant and retain the Series A preferred shares).

If the Series B warrant is exercised, the Series A preferred shares are unaffected and remain outstanding.

Is the Series B warrant a freestanding instrument or a component embedded in the Series A preferred shares?

Analysis

To determine whether the Series B warrant is a freestanding instrument or a component embedded in the Series A preferred shares, FG Corp should consider all of the contractual terms and relevant indicators, including the following points.

□ The Series A preferred shares and Series B warrant were issued contemporaneously and in contemplation of each other. This indicates that the Series B warrant may be an embedded component.

□ The Series B warrant can be separately transferred; the investor does not have to transfer the Series B warrant with the Series A preferred shares. This indicates that the Series B warrant may be a freestanding financial instrument.

□ The Series B warrant can be separately exercised; the Series A preferred shares remain outstanding if the Series B warrant is exercised. This indicates that the Series B warrant may be a freestanding financial instrument.

Based on the above facts, the Series B warrant should be considered a freestanding financial instrument. See FG 7.6 for further information on tranched preferred stock.

Determining whether a component is freestanding or embedded is important because the criteria used to determine the accounting recognition and measurement for freestanding instruments differs from the criteria for embedded components.

5.4 Analysis of an embedded equity-linked component

Once a reporting entity determines that an equity-linked component is embedded in a host instrument, it should assess whether the instrument should be (1) accounted for as a single, hybrid instrument, or (2) separated into the host instrument and the equity-linked component.
ASC 815-15-25-1 provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative under the guidance in ASC 815, Derivatives and Hedging.

**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 this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

Figure 5-2 illustrates the model used to make this assessment.

**Figure 5-2**

Analysis of an embedded equity-linked component

```
Is the hybrid instrument accounted for at fair value and remeasured at fair value through earnings?
No

Determine whether the host instrument is a debt or equity host. Is the embedded equity-linked component clearly and closely related to its host instrument? (FG 5.4.1)
No

Does the embedded equity-linked component meet the definition of a derivative? (FG 5.4.2)
No

Does the embedded derivative qualify for the scope exception for certain contracts involving an issuer’s own equity? (FG 5.4.3)
Yes

Separately account for the embedded derivative (FG 5.4.4)
No

Do not separate embedded component from the hybrid instrument.
Yes
```

5.4.1 **Determine whether the embedded equity-linked component is clearly and closely related to its host instrument**

When considering whether an embedded equity-linked component is clearly and closely related to its host instrument, a reporting entity should first determine whether the host is an equity host or a debt host. An embedded equity-linked component is generally considered clearly and closely related to an equity host; it is not considered clearly and closely related to a debt host.

5.4.1.1 **Determining the nature of the host contract for an equity-linked preferred share**

A host contract is the instrument or contract that would be issued if a hybrid instrument did not contain an embedded component; it’s the hybrid instrument without the embedded component. To determine its nature, the reporting entity needs to consider the host contract’s underlying economic characteristics and risks.

Sometimes, the nature of the host contract is straightforward; a hybrid instrument that is legally a debt instrument has a debt host contract. However, determining whether a hybrid instrument that is legally an equity instrument (e.g., a preferred share) is a debt or equity host contract requires judgment. As discussed in ASC 815-15-25-17A, all of the contractual and implied terms of the preferred share, such as the existence of a redemption feature or conversion option, should be considered when determining the nature of the host instrument as debt or equity.

**ASC 815-15-25-17A**

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.

**Excerpt from ASC 815-15-25-17C**

When applying the guidance in paragraph 815-15-25-17A, ...an entity shall consider not only whether the relevant terms and features are debt-like versus equity-like, but also the substance of those terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances). In assessing the substance of the relevant terms and features, each of the following may form part of the overall analysis and may inform an entity’s overall consideration of the relative importance (and, therefore, weight) of each term and feature among other terms and features:
a. The characteristics of the relevant terms and features themselves (for example, contingent versus noncontingent, in-the-money versus out-of-the-money)

b. The circumstances under which the hybrid financial instrument was issued or acquired (for example, issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized)

c. The potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes. The assessment of the potential outcomes may be qualitative in nature.

Figure 5-3 shows some common attributes that should be analyzed to determine the nature of the host contract. None of these factors alone is determinative of the nature of a host contract; the terms and conditions as a whole should be evaluated. ASC 815-15-25-17D provides additional guidance on assessing each of these attributes.

**Figure 5-3**  
Analyzing the nature of the host contract

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Indicates the instrument is debt-like</th>
<th>Indicates the instrument is equity-like</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redemption provision</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Conversion option</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Cumulative or mandatory fixed dividends</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Discretionary dividends based on earnings</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Voting rights</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Collateral requirement</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Participation in the residual equity of the issuer</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Preference in liquidation</td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

Whether the host contract is a debt host or an equity host does not determine the instrument’s balance sheet classification. For example, a preferred stock contract that has a debt host for purposes of evaluating embedded components should not necessarily be classified as debt by the issuer.

Example 5-2, Example 5-3 and Example 5-4 illustrate the analysis used to determine whether the nature of a preferred stock host contract is more debt-like or equity-like.
EXAMPLE 5-2
Convertible, redeemable preferred equity issued by a thinly capitalized entity

FG Corp, an early stage software company, developed a software solution that is licensed to small and medium-sized enterprises. In its most recent fiscal year, FG Corp recorded sales of $6 million, a 200% increase over the prior year, and a net loss of $2 million. Management estimates that existing cash on hand is sufficient to fund FG Corp’s operations for an additional 3 months.

To date, FG Corp has raised $7 million of equity financing (common stock) and $4 million of debt financing (bank debt). FG Corp has not historically paid dividends and it does not expect to do so in the near to intermediate term.

To raise capital to finance its future operating needs, FG Corp issues Series A preferred stock with a $2 million par value ($2.00 per share) to a single investor, Investor Co. All capital raised by FG Corp will be utilized to increase the size of its sales force and enhance its current software development capabilities.

The key terms of the Series A preferred stock are:

- 8% cumulative, fixed-rate dividends (increases the liquidation preference if not paid in cash)
- Convertible into common stock on a 1:1 basis anytime at the option of the holder
- Automatically converts into common stock upon an initial public offering or sale of the company
- Redeemable at the option of the holder after 5 years for cash equal to the par value of the Series A preferred stock plus accrued and unpaid dividends
- Voting rights on all significant matters submitted for common stockholder vote on an as-converted basis
- Participates in common stock dividends on an as-converted basis
- No creditor rights
- No collateral requirements

The fair value of FG Corp’s common equity was $1.40 per share on the date the preferred stock was issued. FG Corp’s stock price is volatile and could change significantly based on future sales and profitability.

At the time the Series A preferred stock was issued, FG Corp reported an accumulated deficit of $7 million. Based on its current capitalization and stage of operations, there is significant uncertainty regarding FG Corp’s ability to settle the redemption feature in five years, if exercised. Although FG Corp’s current financial position is tenuous, Investor Co expects the business to perform well over time and to exit its investment through conversion into FG Corp’s common equity (through a public offering).

Is the nature of the preferred stock host contract more debt-like or equity-like?
Analysis

When considering all relevant terms and features (i.e., the “whole instrument” approach), the host contract should be considered an equity host.

The existence of cumulative, fixed-rate dividends and a non-contingent redemption feature that is exercisable in five years may indicate the existence of a debt host. However, mitigating considerations exist, including the fact that the realization of these dividends may be tied to the redemption of the instrument, which may not occur, and if redemption is required, there is significant uncertainty as to FG Corp’s ability to fund those dividends.

In contrast, the conversion feature would appear to be a strong indicator that the host contract is more akin to an equity host contract. At the time Investor Co acquired the Series A preferred stock, Investor Co understood that FG Corp might encounter going concern issues if an initial public offering or sale of the company did not occur, and that its economic return was therefore tied to a successful initial public offering or sale.

Other equity-like terms and features include the voting rights and common stock dividend participation rights. Because Investor Co has the ability to vote on all significant matters submitted for shareholder vote, the voting feature should be weighed more heavily in the host contract determination than if they were only permitted to vote on protective matters. The ability of Investor Co to participate in common stock dividends on an as-converted basis should not heavily influence the host contract determination, because FG Corp has not paid, and is not expected to pay dividends to common shareholders in the near term. The investor’s return of and on its capital is highly dependent upon the business performing successfully and an expected exit through the conversion feature.

Although the Series A preferred stock is redeemable at the option of Investor Co after five years, the instrument’s payoff profile is inconsistent with a fixed-income investment with the upside of a residual interest through the conversion feature. If the redemption feature is exercised, FG Corp may lack sufficient assets to redeem the instrument, or may be legally prohibited from doing so if that action would cause FG Corp to become insolvent. Given FG Corp’s current financial position and the uncertainty regarding its wherewithal to perform under this potential future obligation, the redemption feature should not be weighed heavily in the host contract determination. This suggests the Series A preferred stock is, in substance, a residual interest in FG Corp.

The host contract contains no creditor rights that would indicate that it is more akin to a debt host contract (e.g., rights to force FG Corp into bankruptcy or participate in a creditor committee to force the company to reorganize or liquidate). The substance of the liquidation preference is questionable and should not heavily influence the host contract determination, because Investor Co is unlikely to receive cash or assets equal to a stated liquidation should the company liquidate.

Investor Co appears to be taking residual equity risk, and its ability to achieve a meaningful economic return is dependent upon FG Corp’s successful performance and undertaking of an initial public offering or sale to a third party. As a result, the considerations described above indicate that the Series A preferred stock represents an in-substance residual interest in FG Corp and the host contract should be considered to be equity.
EXAMPLE 5-3
Convertible, redeemable preferred equity with creditor rights issued by a thinly capitalized entity

FG Corp, an early stage software company, developed a software solution that is licensed to small and medium-sized enterprises. In its most recent fiscal year, FG Corp recorded sales of $6 million, a 200% increase over the prior year, and a net loss of $2 million. Management estimates that existing cash on hand is sufficient to fund FG Corp’s operations for an additional 3 months.

To date, FG Corp has raised $7 million of equity financing (common stock) and $4 million of debt financing (bank debt). FG Corp has not historically paid dividends and it does not expect to do so in the near to intermediate term.

To raise capital to finance its future operating needs, FG Corp issued Series A preferred stock with a $2 million par value ($2.00 per share) to a single investor, Investor Co. All capital raised by FG Corp will be utilized to increase the size of its sales force and enhance its current software development capabilities.

The key terms of the Series A preferred stock are:

- 8% cumulative, fixed-rate dividends (increases the liquidation preference if not paid in cash)
- Convertible into common stock on a 1:1 basis anytime at the option of the holder
- Automatically converts into common stock upon an initial public offering or sale of the company
- Redeemable at the option of the holder after 5 years for cash equal to the par value of the Series A preferred stock plus accrued and unpaid dividends
- Voting rights on all significant matters submitted for common stockholder vote on an as-converted basis
- Participates in common stock dividends on an as-converted basis
- No creditor rights
- No collateral requirements

The fair value of FG Corp’s common equity was $1.40 per share on the date the preferred stock was issued. FG Corp’s stock price is volatile and could change significantly based on future sales and profitability. Public Corp, a well-capitalized public registrant with an investment-grade credit rating, owns a majority of FG Corp’s common equity.

At the time Investor Co acquired the Series A preferred stock, significant uncertainty existed regarding the likelihood of an initial public offering. To mitigate this risk, Investor Co requested that Public Corp guarantee FG Corp’s obligation to redeem the Series A preferred stock. If FG Corp is unable to perform upon exercise of the redemption feature, Public Corp is obligated to satisfy any part of FG Corp’s obligation that remains unfulfilled (i.e., Public Corp has guaranteed FG Corp’s written put option on its Series A preferred stock). If Public Corp fails to perform on its guarantee, Investor Co may pursue
legal recourse against Public Corp and would have creditor rights against Public Corp if it failed to perform.

Is the nature of the preferred stock host contract more debt-like or equity-like?

**Analysis**

When considering all relevant substantive terms and features, the host contract should be considered a debt host.

With the exception of the stated dividends, expected outcome and the non-contingent fixed-rate redemption feature, all other factors would be evaluated in a manner consistent with Example 5-2.

In this fact pattern, the mandatory conversion feature would be weighted less heavily given the uncertainty surrounding the likelihood of an initial public offering. This uncertainty is underscored by Investor Co’s request for Public Corp’s guarantee of the redemption feature, as it indicates that there is a high probability that Investor Co will realize its investment through exercise of the redemption feature.

Although Investor Co may not receive the stated dividends on a current basis, it can eventually realize the value of the dividends in cash upon exercise of the redemption feature.

With respect to the redemption feature, although concerns regarding FG Corp’s obligation to perform if the instrument is redeemed exist, Public Corp’s guarantee of FG Corp’s obligation to perform upon redemption influences the substance of the Series A preferred stock’s liquidation preference. Furthermore, the presence of creditor rights should FG Corp and Public Corp fail to redeem the preferred shares upon exercise is a strong indicator of the presence of a debt host contract.

Considering the high probability that Investor Co will exit its investment through exercise of the redemption feature, Public Corp’s guarantee of the redemption feature, the substance of the liquidation preference, and the significant risk associated with the conversion feature, the Series A preferred stock represents an in-substance fixed-income investment with residual “upside” and the host contract should be considered a debt host.

**EXAMPLE 5-4**

Convertible, redeemable preferred equity with a high likelihood of conversion

In order to satisfy increased demand for its products, Issuer Corp plans to finance the acquisition of new manufacturing equipment through the issuance of convertible preferred stock at a par value of $2 per share. The terms of the preferred stock are as follows:

- Redeemable at par plus accumulated and unpaid dividends upon a vote of 66% of the holders of preferred stock. The preferred stock is held by a large number of unrelated investors, none of whom individually own more than 5% of the preferred stock issued. The investor group is diverse and includes short-term investors, long-term investors, and strategic investors.

- The purpose of the redemption feature is to provide the investor group with protective rights

- Convertible at the option of the holder after 5 years on a 1:1 basis into Issuer Corp’s common shares. Issuer Corp’s stock price on the issuance date is $1.80 per share.
- Voting rights on all significant matters submitted for common stockholder vote on an as-converted basis
- Participation in common stock dividends on an as-converted basis. Issuer Corp has historically paid dividends on its common stock and expects to continue to do so.
- No creditor rights
- No collateral requirements

Investors in Issuer Corp’s preferred stock expect to exit their investment through exercise of the embedded conversion option.

Is the nature of the preferred stock host contract more debt-like or equity-like?

**Analysis**

When considering all substantive relevant terms and features, the host contract should be considered an equity host.

The holder’s conversion feature is substantive and therefore should be ascribed weight in the host contract determination. In addition, the preferred stock entitles its holder to vote on all significant matters. As described in ASC815-15-25-17D(c), voting rights are generally viewed as an equity-like feature, and are given more weight in the host contract determination when the investor has the ability to vote on all significant matters (as opposed to being voting rights that are designed to be protective in nature). Finally, the preferred stock entitles its holder to participate in dividends on the same basis as the common stock holders, another equity-like feature. This feature would be weighted more heavily given that Issuer Corp has historically paid dividends and expects to do so for the foreseeable future.

Although a fixed price redemption feature exists and would be considered a debt-like characteristic, this feature is considered to be more protective in nature and requires 66% of the holders of the preferred stock to vote to exercise it. Given that the preferred stock is widely held by a diverse group of investors with different investment objectives, together with the fact that none of the preferred stockholders are related parties, there are constraints to exercising the redemption feature. As such, the fixed price redemption feature is considered more protective in nature and would be ascribed less weighting in the host contract determination.

Given the additional weight ascribed to the equity-like conversion feature relative to the debt-like redemption option, and the investors’ ability to vote on all significant matters and participate in dividends with the common stock holders, the host contract should be considered an equity host.

---

**5.4.2 Determine whether the embedded equity-linked component meets the definition of a derivative**

ASC 815-10-15-83 provides the definition of a derivative instrument.
ASC 815-10-15-83
A derivative instrument is a financial instrument or other contract with all of the following characteristics:

a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:

1. One or more underlyings

2. One or more notional amounts or payment provisions or both.

b. Initial net investment. The contract 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.

c. Net settlement. The contract can be settled net by any of the following means:

1. Its terms implicitly or explicitly require or permit net settlement.

2. It can readily be settled net by a means outside the contract.

3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

When evaluating whether an equity-linked component meets the definition of a derivative, the net settlement provision in ASC 815-10-15-83(c) often receives the most attention; the provisions in ASC 815-10-15-83(a) and ASC 815-10-15-83(b) are generally met. To determine whether the net settlement criterion in ASC 815-10-15-83(c) is met, a reporting entity should first determine whether gross physical settlement is required. Gross physical settlement occurs when the asset to be delivered in settlement is both (1) related to the underlying and (2) delivered in quantities equal to the equity component’s notional amount. If gross physical settlement is required, a reporting entity should analyze whether the asset (e.g., shares) to be delivered at settlement is readily convertible to cash. The following considerations are typically relevant to that analysis.

□ Whether the shares received upon settlement are publicly traded

□ Whether the number of shares to be exchanged is large relative to the daily transaction volume

□ The effect of any restrictions on the future sale of any shares received

A reporting entity should also consider the appropriate unit of account when determining whether the asset to be delivered at settlement is readily convertible to cash. In assessing whether a contract which can contractually be settled in increments meets the definition of net settlement, a reporting entity must determine whether or not the quantity of the asset to be received from the settlement of one increment is considered readily convertible to cash. If the contract can be settled in increments and those increments are considered readily convertible to cash, the entire contract meets the definition of net settlement.
If gross physical settlement is not required, an equity-linked component may nevertheless meet the net settlement provisions in ASC 815-10-15-83(c)(1) or 15-83(c)(2). See DH 2 for further information on how to determine whether a contract meets the definition of a derivative.

5.4.3 **Determine whether the embedded component qualifies for the scope exception for certain contracts involving a reporting entity’s own equity**

As discussed in FG 5.4, an embedded component should be separated from its host instrument and accounted for separately as a derivative when it meets the criteria in ASC 815-15-25-1, unless the embedded derivative qualifies for a scope exception.

An embedded equity-linked component that meets the definition of a derivative does not have to be separated from its host instrument if the component qualifies for the scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

**Excerpt from ASC 815-10-15-74**

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
   2. Classified in stockholders’ equity in its statement of financial position.

An embedded component is considered indexed to a reporting entity’s own stock if it meets the requirements specified in ASC 815-40-15. See FG 5.6.2 for information on these requirements.

An embedded component would be classified in shareholders’ equity if it meets the requirements for equity classification in ASC 815-40-25. See FG 5.6.3 for information on these requirements.

5.4.4 **Accounting for separated instruments**

When a reporting entity separates an embedded derivative from a hybrid instrument, the accounting for the host contract should be based on the accounting guidance applicable to similar host contracts of that type. ASC 815-15-30-2 through ASC 815-15-30-6 provide guidance on allocating the carrying amount of the hybrid instrument between the host contract and the derivative. That guidance requires the derivative to be recorded at fair value and the carrying value assigned to the host contract to represent the difference between the previous carrying amount of the hybrid instrument and the fair value of the derivative; therefore, there is no gain or loss from the initial recognition and measurement of an embedded derivative that is accounted for separately from its host contract.

If the embedded derivative is not an option (e.g., it is a forward component), the terms of the non-option embedded derivative should be determined such that the fair value is zero at inception.
If the embedded derivative is an option, ASC 815-15-30-6 requires the option to be separated and recorded at its fair value based on its stated contract terms. The allocation of proceeds to the separated derivative will typically create a discount or premium in the associated host debt or equity security.

5.4.5 **Reassessment of embedded components**

While an analysis of the clearly and closely related criterion in ASC 815-15-25-1(a) is generally a one-time assessment, the remaining criteria in ASC 815-15-25-1 require an ongoing assessment. Therefore, embedded components should be reassessed at the end of each reporting period to determine whether (1) an embedded component that has not been separated from its host should be separated or (2) a separated derivative no longer meets the requirements for separation.

5.5 **Application of ASC 480**

The guidance in ASC 480 applies to freestanding equity and equity-linked financial instruments and requires a reporting entity to classify certain freestanding financial instruments as liabilities (or in some cases as assets).

5.5.1 **Scope of ASC 480**

One of the instruments within the scope of ASC 480 is a mandatorily redeemable financial instrument, which is defined in ASC 480-10-20.

**Definition from ASC 480-10-20**

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.

ASC 480-10-25-4, 25-5, 25-8 and 25-14 provide guidance on which instruments are within the scope of ASC 480. Certain mandatorily redeemable financial instruments issued by nonpublic entities are not within the scope of ASC 480, as discussed in FG 5.5.1.4.

**ASC 480-10-25-4**

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.

**ASC 480-10-25-5**

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.

**ASC 480-10-25-8**

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.

**ASC 480-10-25-14**

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.

The term “monetary value” is defined in ASC 480-10-20; ASC 480-10-55-2 provides application examples.

Question 5-1 discusses whether a purchased option is within the scope of ASC 480.

**Question 5-1**

Is a purchased option within the scope of ASC 480?

**PwC response**

No, a purchased option, such as a purchased call option, does not create an obligation to repurchase shares; it provides the reporting entity with the right but not the obligation to repurchase shares. Further, ASC 480 does not apply to contracts that will always be classified as an asset by the reporting entity as a purchased option would be.

Question 5-2 discusses whether instruments settled in, or indexed to, the common stock of a consolidated subsidiary are within the scope of ASC 480.
**Question 5-2**

Are instruments settled in, or indexed to, the common stock of a consolidated subsidiary within the scope of ASC 480?

*PwC response*

It depends. ASC 480-10-20 defines an issuer’s equity shares.

**Definition from ASC 480-10-20**

Issuer’s Equity Shares: The equity shares of any entity whose financial statements are included in the consolidated financial statements.

Therefore, an instrument settled in, or indexed to, a consolidated subsidiary’s common stock is within the scope of ASC 480 provided the instrument meets the other criteria in ASC 480. For example, a freestanding written put option on a subsidiary’s outstanding shares is within the scope of ASC 480-10-25-8 if cash settled; and within the scope of ASC 480-10-25-14(c) if net share settled. A freestanding purchased call on those same shares is not within the scope of ASC 480 because it does not obligate the reporting entity.

**5.5.1.1 Meaning of “predominantly”**

An obligation to issue a variable number of shares is within the scope of ASC 480 if the monetary value is based either solely or predominately on one of the three items listed in ASC 480-10-25-14. The term predominately is included to preclude ASC 480 from being circumvented by embedding a small amount of variability in an instrument based on the reporting entity’s equity share price.

ASC 480-10-55-44 provides guidance on performing this analysis. ASC 480-10-55-45 through ASC 480-10-55-52 provides examples of the application of ASC 480-10-25-14.

**Excerpt from ASC 480-10-55-44**

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.

ASC 480 does not provide explicit guidance on the meaning of “predominantly”; it could mean “more-likely-than-not” (i.e., 50.1%, consistent with predominance, defined as the “greater amount”) or some higher threshold (e.g., 90%, consistent with the objective of not allowing the standard to be circumvented by embedding a “small” amount of variability). We believe that “predominantly,” as used in ASC 480-10-25-14, can be interpreted as either a “more-likely-than-not” or a higher threshold; a reporting entity should elect an accounting policy and apply it consistently.
5.5.1.2 **Financial instrument with multiple components**

ASC 480-10-55 provides several examples of the application of the scope provisions to certain freestanding instruments comprised of more than one option or forward contract.

As discussed in ASC 480-10-25-15, two or more freestanding financial instruments should generally not be combined to determine whether the instruments are within the scope of ASC 480; however, if the instruments should be combined under the provisions of ASC 815-10-15-8, they should also be combined for purposes of applying ASC 480. Since ASC 480 requires a separate contract-by-contract evaluation, oftentimes the accounting treatment will be dictated by whether different instruments are structured in a single contract or entered into as separate contracts. Figure 5-4 provides examples of instruments that may have different accounting based on whether they are executed as a single instrument or multiple instruments.

**Figure 5-4**
Accounting for instruments with multiple components

<table>
<thead>
<tr>
<th>Separate freestanding contracts</th>
<th>Within scope of ASC 480</th>
<th>Outside scope of ASC 480</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Written put option</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>b. Purchased call option</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>c. Outstanding share of common stock</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>d. Purchased put option</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>e. Written call option on non-redeemable stock</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>f. Written call option on redeemable stock</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Combined (single) contract</th>
<th>Within scope of ASC 480</th>
<th>Outside scope of ASC 480</th>
</tr>
</thead>
<tbody>
<tr>
<td>g. Collar (e.g., a written put @ $10/share and a purchased call @ $18/share)</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>h. Net purchased put option (e.g., a purchased put @ $12/share and a written put @ $10/share)</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>i. Net written put option (e.g., a written put @ $12/share and a purchased put @ $10/share)</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>j. Collar and outstanding share of common stock</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>
Separate freestanding contracts

<table>
<thead>
<tr>
<th></th>
<th>Within scope of ASC 480</th>
<th>Outside scope of ASC 480</th>
</tr>
</thead>
<tbody>
<tr>
<td>k. Puttable stock (i.e., outstanding share of common stock and written put option)</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

As Figure 5-4 illustrates:

- A freestanding written put option (a) falls within the scope of ASC 480, but a purchased call option (b) is outside the scope of ASC 480; however, if the written put option and purchased call option are combined into a single contract, that collar contract, as in (g), is within the scope of ASC 480.

- A written put option may be outside the scope of ASC 480 if it is completely eliminated by a purchased put option in a combined contract, as is the case in (h); however, if the written put option is only partially offset by the purchased put option and thus creates a net written put option, the entire contract is within the scope of ASC 480, as is the case in (i).

- A separate written put option (a) and an outstanding share of common stock (c) are accounted for differently than puttable stock, as in (k), which is a combination of an outstanding share of stock and a written put option.

5.5.1.3 Disregard nonsubstantive or minimal features

As noted in FG 5.5.1, ASC 480 applies only to certain freestanding financial instruments. To avoid attempts to circumvent the application of ASC 480 by embedding a minimal or nonsubstantive feature in a freestanding financial instrument, the guidance specifies that nonsubstantive features should be disregarded when determining whether ASC 480 applies. ASC 480 provides examples of features that may be considered nonsubstantive.

The assessment of whether a feature is minimal or nonsubstantive is performed only at inception of a financial instrument; no further assessment is required. This assessment requires judgment and must consider not only the legal terms of an instrument, but also other relevant facts and circumstances.

As discussed in FG 5.5.1.2, a written put option is classified as a liability under ASC 480 because it obligates the reporting entity to deliver cash to repurchase shares. On the other hand, a written put in a share of stock is not classified as a liability. However, as illustrated in ASC 480-10-55-41, a reporting entity that embeds a written put option into a nonsubstantive host instrument should disregard that host instrument and account for the written put option as a liability.

**ASC 480-10-55-41**

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.

If a share of mandatorily redeemable preferred stock contains a conversion feature, it would not be classified as a liability due to the inclusion of the conversion feature. However, as illustrated in ASC 480-10-55-12, if the conversion price at inception is extremely high relative to the current share price (so that the likelihood of the stock price ever reaching the conversion price is remote), it would be considered nonsubstantive and therefore, disregarded.

**ASC 480-10-55-12**

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.

A conversion option that is nonsubstantive at inception is always considered nonsubstantive in subsequent periods. Similarly, a conversion option that is substantive at inception is always considered substantive and does not subsequently become nonsubstantive as a result of a substantial decline in the issuer’s stock price.

Although a feature may be nonsubstantive for purposes of applying ASC 480, that feature should not necessarily be ignored for other accounting purposes.

**5.5.1.4 Mandatorily redeemable financial instruments issued by nonpublic reporting entities**

Mandatorily redeemable financial instruments issued by nonpublic reporting entities are not within the scope of ASC 480 provided they are not redeemable (1) on a fixed date, (2) for a fixed amount, or (3) for an amount determined by reference to an interest rate, currency or other index. A reporting entity is considered nonpublic for purposes of this scope exception provided it does not have publicly traded securities and is not required to file financial statements with the SEC.

If a mandatorily redeemable financial instrument is not within the scope of ASC 480, the disclosure requirements for mandatorily redeemable instruments in ASC 505 are still required. See FSP 5 for further information on the disclosure requirements of mandatorily redeemable instruments.

**5.5.2 Initial measurement and recognition**

Financial instruments within the scope of ASC 480, other than physically settled forward repurchase contracts, should be initially measured at fair value. See FG 9.2.2.1 for information on physically settled forward repurchase contracts.

Financial instruments that fall into the scope of ASC 480 subsequent to issuance (e.g., conditionally redeemable preferred stock that becomes mandatorily redeemable) should be reclassified as a liability and initially measured at fair value. No gain or loss should be recorded as a result of the reclassification.
5.5.3 **Subsequent measurement**

Most financial instruments within the scope of ASC 480 should be subsequently measured at fair value, with changes in fair value recorded in earnings, typically as other income or expense. The two instruments within the scope of ASC 480 that are not measured at fair value are (1) mandatorily redeemable instruments and (2) physically settled forward repurchase contracts for a fixed number of shares. See FG 7.3.1.1 for information on mandatorily redeemable instruments. See FG 9.2.2.1 for information on physically settled forward repurchase contracts.

5.6 **Analysis of a freestanding equity-linked instrument**

Once a reporting entity has determined that a freestanding financial instrument should not be accounted for using the guidance in ASC 480, the next step is to determine whether the instrument should be accounted for as (1) an equity instrument or (2) a liability (or in some cases an asset) under the guidance in ASC 815-40, *Derivatives and Hedging – Contracts in Entity’s Own Equity*. Figure 5-5 summarizes the steps in the analysis of a freestanding equity-linked instrument.

**Figure 5-5**
Analysis of a freestanding equity-linked instrument

![Figure 5-5](image-url)
As illustrated in Figure 5-5, the steps used to analyze a freestanding equity-linked instrument differ from the analysis of an embedded equity-linked component. An embedded equity-linked component must meet the definition of a derivative in ASC 815-10-15-83 to be subject to the guidance in ASC 815-40. Consequently, an embedded non-derivative equity-linked component should not be accounted for separately.

A freestanding instrument, on the other hand, does not need to meet the definition of a derivative to be subject to the guidance in ASC 815-40, which may require classification of the instrument as a liability (or in some cases as an asset) measured at fair value. For example, a freestanding warrant on the shares of a private reporting entity may not meet the definition of a derivative because it cannot be net settled and the underlying equity is not readily convertible to cash. However, the instrument should be analyzed to determine whether it would be considered indexed to the reporting entity’s own stock in order to determine whether the instrument is within the scope of the guidance on additional requirements for equity classification. An instrument that is considered indexed to a reporting entity’s own stock should be evaluated to determine if it meets the requirements for equity classification in ASC 815-40-25; see FG 5.6.3. If these requirements are met, equity classification is appropriate and the instrument should be initially measured at fair value with no subsequent remeasurement. If the requirements for equity classification are not met, the instrument should be classified as an asset or liability and recorded at fair value with changes in fair value recorded in the income statement.

If an instrument is not considered indexed to the reporting entity’s own stock and does not meet the definition of a derivative, it is required to be classified as an asset or a liability. However, ASC 815-40 does not provide further guidance with respect to the appropriate accounting and measurement basis. The appropriate accounting treatment should be determined by analyzing the terms of the instrument and the nature of the transaction giving rise to its issuance.

5.6.1 **Determine whether the freestanding instrument meets the definition of a derivative**

ASC 815-10-15-83 provides the definition of a derivative instrument; see FG 5.4.2 for the text of ASC 815-10-15-83. As discussed in FG 5.4.2, the net settlement provision in ASC 815-10-15-83(c) often receives the most attention because the provisions in ASC 815-10-15-83(a) and ASC 815-10-15-83(b) are generally met.

A freestanding equity-linked instrument meets the net settlement criterion in ASC 815-10-15-83(c)(1) if it can be net share settled, even if the underlying shares are not readily convertible to cash, as illustrated in ASC 815-10-55-90.

**ASC 815-10-55-90**

This Example illustrates the concept of net share settlement. Entity A has a warrant to buy 100 shares of the common stock of Entity X at $10 a share. Entity X is a privately held entity. The warrant provides Entity X with the choice of settling the contract physically (gross 100 shares) or on a net share basis. The stock price increases to $20 a share. Instead of Entity A paying $1,000 cash and taking full physical delivery of the 100 shares, the contract is net share settled and Entity A receives 50 shares of stock without having to pay any cash for them. (Net share settlement is sometimes described as a cashless exercise.) The 50 shares are computed as the warrant’s $1,000 fair value upon exercise divided by the $20 stock price per share at that date.
A freestanding instrument may also meet the net settlement criterion if it can be transferred, or if the shares underlying the instrument are readily convertible to cash. See FG 5.4.2 and DH 2 for further information on the definition of a derivative.

5.6.2 **Determine whether the instrument is indexed to a reporting entity’s own stock**

ASC 815-40-15 addresses when an instrument, or embedded component that meets the definition of a derivative, is considered indexed to a reporting entity’s own stock. The guidance requires a reporting entity to apply a two-step approach—it requires the evaluation of an instrument’s or embedded component’s contingent exercise provisions and then the instrument’s or embedded component’s settlement provisions.

ASC 815-40-55-26 through ASC 815-40-55-48 contain a number of examples illustrating the application of the two-step approach to determining whether an instrument is indexed to a reporting entity’s own stock.

5.6.2.1 **Step one — exercise contingencies**

Any contingent provision that affects the holder’s ability to exercise the instrument or embedded component must be evaluated. For example, holders may have a contingent exercise right or may have their right to exercise accelerated, extended, or eliminated upon satisfaction of a contingency.

- If an exercise contingency is based on the occurrence of an event, such as an IPO, the contingency does not affect the conclusion that the freestanding instrument or embedded component is indexed to a reporting entity’s own stock.

- If an exercise contingency is based on an observable index, then the presence of the exercise contingency precludes a freestanding instrument or embedded component from being considered indexed to a reporting entity’s own stock with two exceptions. A contingency based on the following would not preclude the instrument or embedded component from being considered indexed to the reporting entity’s own stock.
  - The reporting entity’s stock price
  - An index calculated or measured solely by reference to the reporting entity’s own operations (e.g., sales revenue, EBITDA)

For example, if a warrant becomes exercisable only if the S&P 500 increases by 10% or the price of oil decreases by 10%, the contingency would fail this step and the warrant would not be considered indexed to the reporting entity’s own stock. In contrast, if the warrant became exercisable only if the reporting entity’s stock price increased 10%, this step of the guidance would be met and the analysis would proceed to step two.

5.6.2.2 **Step two — settlement provisions**

ASC 815-40-15-7C provides guidance on how to evaluate an instrument’s settlement provisions to determine whether the instrument is indexed to the reporting entity’s own stock. This guidance is often referred to as the “fixed for fixed” rule.
Equity-linked instruments model

**ASC 815-40-15-7C**
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.

The strike price or the number of shares used to calculate the settlement amount is not considered fixed if the terms of the instrument or embedded component allow for any potential adjustment (except as discussed below), regardless of the probability of the adjustment being made or whether the reporting entity can control the adjustment.

ASC 815-40-15-7E discusses the exception to the “fixed for fixed” rule. This exception allows an instrument to be considered indexed to the reporting entity’s own stock even if adjustments to the settlement amount can be made, provided those adjustments are based on standard inputs used to determine the value of a “fixed for fixed” forward or option on equity shares.

**ASC 815-40-15-7E**
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.
Including other variables, or incorporating a leverage factor that increases the instrument’s exposure to the variables in ASC 815-40-15-7E, would preclude the instrument from being considered indexed to the reporting entity’s own stock.

**Antidilution and price protection provisions (including “down round” features)**

Settlement adjustments designed to protect a holder’s position from being diluted by a transaction initiated by an issuer will generally not prevent a freestanding instrument or embedded component from being considered indexed to the issuer’s own stock provided the adjustments are limited to the effect that the dilutive event has on the shares underlying the instrument. Common examples of acceptable adjustments include the occurrence of a stock split, rights offering, stock dividend, or a spinoff. In addition, settlement adjustments due to issuances of shares for an amount below current fair value, or repurchases of shares for an amount that exceeds the current fair value of those shares, should also be acceptable.

Not all “antidilution” settlement adjustments will meet the criteria for being considered indexed to a reporting entity’s own stock in ASC 815-40-15. Settlement adjustments that overcompensate the holder (i.e., the potential adjustments exceed the potential impact of the dilution) prevent a freestanding instrument or embedded component from being considered indexed to the reporting entity’s own stock.

Some equity-linked financial instruments may contain price protection provisions requiring a reduction in an instrument’s strike price as a result of a subsequent at-market issuance of shares below the instrument’s original strike price, or as a result of the subsequent issuance of another equity-linked instrument with a lower strike price. This is typically referred to as a “down round” feature. Down round features are most often found in warrants and conversion options embedded in debt or preferred equity instruments issued by private entities, but may be found in financial instruments issued by public companies.

The issuance of shares for an amount equal to the current market price of those shares is not dilutive. Further, the possibility of a market price transaction occurring at a price below an instrument’s strike price is not an input to the valuation of a standard “fixed for fixed” instrument, and thus it would not qualify for the exception discussed in ASC 815-40-15-7E. Therefore any settlement adjustments related to such events would preclude the reporting entity from considering the instrument or embedded component as indexed to its own stock.

The term “down round” can be applied to provisions with varying terms. As such, a reporting entity should evaluate the specific provision to determine whether it affects the reporting entity’s ability to consider an instrument indexed to its own stock.

**New guidance**

ASU 2017-11, Accounting for Certain Financial Instruments with Down Round Features, provides a definition of a down round feature and guidance on applying the requirements for the down round exception discussed in ASC 815-40-15-7E. The guidance is effective for public business entities in 2019. Nonpublic entities have an additional year to apply the guidance. Early adoption is permitted.

The new guidance effectively makes an exception to the base model for determining when an instrument or an embedded feature is considered solely indexed to an entity’s own stock. Adjustment
provisions should be evaluated to determine whether they meet the definition of a down round. ASU 2017-11 adds a definition of a down round feature to the Master Glossary.

**Definition from Master 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.

As discussed in ASC 815-10-15-75A, a reporting entity can disregard a down round feature that meets this definition when determining whether the instrument is considered indexed to the reporting entity’s own stock. However, when a down round feature is triggered, there are earnings per share implications, as discussed in ASC 260-10-45-12B and FSP 7.4.1.5.

If a feature does not meet the definition of a down round, the instrument must be evaluated under the base model to determine whether it is solely indexed to an entity’s own stock.

Example 5-5 and Example 5-6 illustrate the evaluation of down round features.

**EXAMPLE 5-5**

**Strike price adjustment based on common stock valuation**

Company A, a private company, issues a warrant for the purchase of 100,000 shares of Company A common stock, with a strike price of $10.00. The warrant provides for net settlement in shares and meets the definition of a derivative under ASC 815. The terms of the warrant state that the strike price of the warrant will be reduced if a subsequent valuation indicates that the fair value of Company A’s common stock is below the current strike price. Historically, Company A has prepared a valuation when it issues instruments such as common stock, warrants, and convertible instruments, but it also has had valuations prepared when it issues equity-linked compensation to its employees.

Is the provision regarding the change in the warrant’s strike price a down round feature as defined in the guidance?

**Analysis**

While this feature is similar to a down round feature in that it is designed to protect warrant holders against declines in stock price, the provision does not meet the definition of a down round.

A down round feature contemplates a sale of a company’s stock or issuance of an equity-linked financial instrument. If Company A were to obtain or prepare a valuation of its common stock, this could trigger a reset of the instrument’s strike price, even if no instrument is issued by Company A. For example, Company A may be contemplating issuing equity to raise capital, but may decide to issue
debt based upon the valuation of the common stock. Further, if Company A grants stock options to its employees with vesting requirements, they are not considered issued until they vest under GAAP.

In addition, if Company A were to issue warrants, convertible debt, or convertible preferred stock with a strike price higher than the strike price on the outstanding warrant, but the common stock valuation indicated a common stock price below the outstanding warrant strike price (i.e., Company A issued an out-of-the-money instrument), the strike price on the outstanding warrant would be adjusted downward. This would not be consistent with the definition of a down round, which indicates that the strike price on the outstanding warrant should only be adjusted if the strike price on the issued equity-linked instrument is below the outstanding warrant’s strike price.

**EXAMPLE 5-6**

Adjustment to the number of shares

Company B issues a warrant for the purchase of 100,000 shares of Company B common stock, with a strike price of $10.00. The warrant provides for net settlement in shares and meets the definition of a derivative under ASC 815. The terms of the warrant provide that when Company B sells common stock below the strike price on the warrant or issues a financial instrument with a strike price below the strike price on the warrant, the warrant will be exercisable into more than the initial 100,000 shares. The strike price of the warrant is not adjusted. This feature is designed to ensure that Company B receives a fixed amount of proceeds upon exercise of the warrant.

Is the provision to adjust the number of shares upon exercise of the warrant a down round feature?

**Analysis**

Although the definition of a down round refers only to a reduction in strike price, we believe that an increase in shares underlying the warrant can achieve the same economic objective. Therefore, we believe the provision could be considered a down round feature. As a result, it would not, in isolation, cause an instrument to not be considered indexed to an entity’s own stock. Increasing the number of shares an instrument is exercisable into is the only practical manner in which a down round can be implemented in a convertible instrument.

Although we believe that an increase in the number of shares underlying a warrant and reducing the strike price achieve the same economic objective, we believe that the increase in the number of shares pursuant to such a provision should not permit a transfer of more value to the holder than a reduction of a strike price would. For example, while the definition of a down round would permit the strike price of an instrument to be adjusted below the issuance or strike price of the issued instrument, the amount of value that could be transferred by a strike price reduction is limited as the strike price cannot be reduced below zero.

**5.6.2.3 Foreign currency denominated strike price**

As discussed in ASC 815-40-15-7I, if an instrument’s strike price is denominated in a currency other than the reporting entity’s functional currency, the instrument is not considered indexed to the reporting entity’s own stock. Whether the shares issuable under the instrument are traded in a market in which transactions are denominated in the same foreign currency is irrelevant to the analysis.
5.6.2.4 **Indexed to stock of subsidiary or affiliate**

ASC 815-40-15-5C provides guidance on instruments indexed to the shares of a subsidiary.

**Excerpt from ASC 815-40-15-5C**

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.

This guidance applies to freestanding instruments and embedded components indexed to the stock of a consolidated subsidiary, whether the instrument is entered into by the parent or the subsidiary. The same is not true for instruments indexed to the stock of an affiliate that is not a consolidated subsidiary or stock of an equity method investee. The stock of such an affiliate or equity method investee is not considered the reporting entity's own stock.

5.6.3 **Determine whether the instrument meets the requirements for equity classification**

ASC 815-40-25-1 and ASC 815-40-25-2 provide the general framework for determining whether an instrument that is considered indexed to an issuer's own stock should be classified as a liability (or in some cases, an asset) or equity. Application of this guidance requires a detailed understanding of the settlement provisions and other terms of the instrument being analyzed.

A reporting entity is required to perform the analysis to determine whether the requirements for equity classification have been met. Liability classification is not a default classification; thus, a reporting entity cannot forgo the analysis and assume liability classification. In some cases, the evaluation of various contractual terms may be complicated. In such cases, assistance from legal counsel may be required.

**ASC 815-40-25-1**

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.

**ASC 815-40-25-2**

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.
Therefore:

- Contracts that are settled by gross physical delivery of shares or net share settlement may be equity instruments (see FG 5.6.3.1).
- Contracts that require or permit the investor to require a reporting entity to net cash settle are accounted for as assets or liabilities at fair value with changes in fair value recorded in earnings.
- Contracts that a reporting entity could be required to settle in cash should be accounted for as an asset or liability at fair value, regardless of whether net cash settlement would only occur under a remote scenario.

### 5.6.3.1 Additional requirements for equity classification

It is important to note that not all share-settled contracts qualify for equity classification. For a share-settled contract to be classified as equity, each of the additional conditions in ASC 815-40-25-10 must be met to ensure that the issuer has the ability to settle the contract in shares.

These conditions are intended to identify situations in which net cash settlement could be forced upon the issuer by investors or in any other circumstance, regardless of likelihood, except for (1) liquidation of the issuer or (2) a change in control in which the issuer’s shareholders also receive cash.

**Excerpt from ASC 815-40-25-10**

Because any contract provision that could require net cash settlement precludes accounting for a contract as equity of the entity,...all of the following conditions must be met for a contract to be classified as equity:

- **a.** Settlement permitted in unregistered shares. The contract permits the entity to settle in unregistered shares.
- **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 if entity fails to timely file. There are no required cash payments to the counterparty in the event the entity fails to make timely filings with the Securities and Exchanges Commission (SEC).
- **e.** No cash-settled top-off or make-whole provisions. There are no cash settled top-off or make-whole provisions.
- **f.** No counterparty rights rank higher than shareholder rights. There are no provisions in the contract that indicate that the counterparty has rights that rank higher than those of a shareholder of the stock underlying the contract.
No collateral required. There is no requirement in the contract to post collateral at any point or for any reason.

ASC 815-40-25-11 through ASC 815-40-25-38 provide further guidance on the requirements for equity classification.

**Sequencing of instruments**

When a reporting entity issues new equity or equity-settled contracts, such as employee stock options, it should assess whether the issuance has an effect on previously issued instruments. The criterion in ASC 815-40-25-10(b) that the issuer have sufficient authorized and unissued shares available to settle all of its contracts may no longer be met. When performing this assessment, a reporting entity should follow the guidance in ASC 815-40-25-20. This guidance requires the evaluation to consider the maximum number of shares that could be required to be delivered during the contract period under existing commitments. The effect of the issuance of new equity-linked or equity-settled instruments on previously issued instruments will depend on the terms of each instrument, as well as the reporting entity’s policy for evaluating the sequencing of its instruments (as discussed in Figure 5-6) that may be settled in shares.

For example, if a reporting entity issues warrants and concludes that those warrants should be classified as equity, it must have had sufficient authorized and unissued shares to meet the requirements of ASC 815-40-25-10(b) to reach that conclusion. If the reporting entity subsequently issues common stock, and can no longer assert that it has sufficient authorized and unissued shares to satisfy its outstanding warrants, it should determine which warrants should no longer be classified as equity. Figure 5-6 illustrates some alternative methods that may be applied; there may be other acceptable methods as well.

**Figure 5-6**

Methods of sequencing instruments

<table>
<thead>
<tr>
<th>Methodology</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last-in, first-out (LIFO)</td>
<td>Authorized and unissued shares would first be used to satisfy the most recently issued equity-linked instruments.</td>
</tr>
<tr>
<td>First-in, first-out (FIFO)</td>
<td>Authorized and unissued shares would first be used to satisfy the earliest issued equity-linked instruments.</td>
</tr>
<tr>
<td>Proportionate</td>
<td>Authorized and unissued shares would be applied proportionately to all equity linked instruments outstanding. This methodology results in some portion of each equity-linked instrument failing to meet the requirements for equity classification.</td>
</tr>
</tbody>
</table>

A reporting entity should establish a policy for sequencing instruments and apply that policy consistently.
**Application examples**

Example 5-7, Example 5-8 and Example 5-9 illustrate the application of certain additional requirements for equity classification in ASC 815-40-25-10.

**EXAMPLE 5-7**

Effect of exchange limits on share issuance

Several stock exchanges in the US (e.g., NYSE and NASDAQ) have rules applicable to companies listed on the exchange that limit the number of shares issuable in an unregistered offering without shareholder approval. The rules generally apply to the issuance of common shares (or an instrument that could be settled in common shares) in excess of 20% of the outstanding common shares of the reporting entity.

FG Corp is registered on the NYSE and has 750,000 authorized shares and 500,000 shares issued and outstanding (and therefore 250,000 shares authorized and unissued).

FG Corp issues an unregistered convertible bond to multiple investors that, upon conversion, will result in the issuance of 125,000 shares (25% of outstanding shares). FG Corp concludes that the embedded conversion option meets the definition of a derivative and must be evaluated to determine whether the scope exception in ASC 815-10-15-74(a) can be applied. FG Corp has not obtained shareholder approval to issue the shares upon conversion of the bond.

Can the conversion option embedded in FG Corp’s convertible bond meet the requirements for the scope exception in ASC 815-10-15-74(a)?

**Analysis**

No. If FG Corp’s shareholders do not vote to approve the issuance of shares upon conversion of the bond, FG Corp will be prohibited by the NYSE from issuing shares in excess of 20% of its outstanding shares. In that case, upon conversion, the guidance assumes that investors will receive cash equal to the fair value of the share shortfall. Since shareholder approval is not within the control of FG Corp, the possibility of this outcome, however remote, precludes equity classification for any part of the contract that may require cash settlement.

**EXAMPLE 5-8**

Convertible debt indexed to subsidiary’s stock and settleable in stock of parent or subsidiary

Parent Corp, a public company, has a subsidiary, Sub Inc, which is also a public company.

Parent Corp has issued convertible debt, which upon conversion can be settled in either Parent Corp or Sub Inc shares at the discretion of Parent Corp. The value that investors will receive (i.e., the conversion value) is indexed solely to the stock price of Sub Inc. The ability to satisfy the conversion value in Parent Corp’s shares is merely a settlement mechanism and does not affect the value.

Can the conversion option embedded in Parent Corp’s convertible bond meet the requirements for the scope exception in ASC 815-10-15-74(a) for contracts issued or held by the reporting entity that are both (i) indexed to its own stock and (ii) classified in stockholders’ equity in its statement of financial position?
Analysis

Probably. As discussed in ASC 815-40-15-5C, an instrument issued by a parent indexed to the stock of a consolidated subsidiary should be considered indexed to its own stock provided the subsidiary is a substantive entity. Since Sub Inc is a substantive entity, Parent Corp must determine whether the embedded conversion option meets the requirements to apply the ASC 815-10-15-74(a) scope exception.

The value of the conversion option embedded in Parent Corp’s bond is indexed to Sub Inc’s shares. Accordingly, it would be considered indexed to Parent Corp’s own stock based on the guidance in ASC 815-40-15-5C. The settlement mechanism that allows settlement in shares of either Parent Corp or Sub Inc does not affect this conclusion.

If Parent Corp were required to settle the conversion option in shares of Parent Corp, then the contract would need to be evaluated to determine whether it contained an explicit limit on the number of shares to be delivered in a share settlement. If Sub Inc’s share price rose, while Parent Corp’s share price fell, then the number of Parent Corp shares required for delivery could increase substantially. Without a maximum cap on the number of Parent Corp shares that Parent Corp could be required to deliver, and if this was the only settlement option alternative, classification of the conversion feature in shareholders’ equity would not be permitted. In addition, the potential requirement to issue an unlimited number of Parent Corp shares may have implications for other equity classified instruments. The criterion in ASC 815-40-25-10(b) that the reporting entity must have sufficient authorized and unissued shares available to settle all of its contracts may no longer be met. See FG 5.6.3.1 for additional information.

EXAMPLE 5-9

Effect of master netting agreement

FG Corp issues a convertible bond that, upon conversion, will result in cash settlement of the conversion option.

FG Corp also enters into two contracts with a bank:

- A convertible bond hedge (purchased call option) that mirrors the terms of the embedded conversion option in FG Corp’s convertible bond and requires the bank to pay cash to FG Corp equal to the value of the conversion option upon exercise.

- A warrant with a strike price at a 20% premium to the embedded conversion option price that requires FG Corp to deliver net shares to the bank, if the warrant is in the money when the conversion option is exercised.

FG Corp and the bank enter into a master netting agreement that allows the convertible bond hedge and warrant to be netted in determining the amount due in the case of FG Corp’s bankruptcy.

Can the warrant meet the requirements for equity classification?
Analysis

No. Since the convertible bond hedge requires cash settlement, the requirements for equity classification are not met. Because upon bankruptcy, the warrant can be netted with a contract that does not meet the requirements for equity classification, the warrant does not meet the requirements for equity classification. An arrangement that provides for the netting of contracts that meet the requirements for equity classification with those that do not meet the requirements provides the counterparty with rights that rank higher than those of other shareholders. Additionally, the netting effectively provides for net cash settlement of the warrant.

However, a contract that otherwise met the requirements for equity classification, could be included in a netting arrangement with other contracts that meet the requirements for equity classification without tainting the ability to qualify for equity classification.

Question 5-4 discusses whether an issuer should classify convertible preferred equity certificates as a liability or equity for accounting purposes.

**Question 5-4**

Should an issuer classify convertible preferred equity certificates (CPECs) as a liability or equity for accounting purposes?

**PwC response**

CPECs are a tax efficient preferred security, generally issued from an issuer domiciled in Luxembourg. A CPEC may take various forms but is structured such that it is treated as debt for local tax purposes. Typically, a CPEC can be redeemed (i.e., matures) by the issuer 49 years after it is issued, is callable at the issuer's option at any time, has a stated yield, and is convertible into common stock at the option of the investor at any time. The conversion price approximates the fair value of the common stock on the issuance date.

The payment provisions include a qualification which states that the yield or redemption value is only due and payable if the issuer becomes insolvent and will not be insolvent (as defined in the agreement) in the event the issuer makes payment.

While subordinate to the issuer’s other debt, a CPEC ranks in priority to share capital. A CPEC is legal form debt under local law; the holder is not entitled to any voting rights.

We believe CPECs should be classified as liabilities. The CPECs are not within the scope of ASC 480, despite the mandatory redemption date in 49 years, because there is a substantive conversion option. However, the investor is granted creditor rights, including the right to force bankruptcy; therefore, we do not believe CPECs meet the requirements for equity classification in ASC 815-40-25-10. In addition, as legal form debt, CPEC's are not considered redeemable preferred stock under ASC 480-10-S99 (i.e., they are not mezzanine equity).

**5.6.4 Other applicable GAAP**

A reporting entity should apply other appropriate GAAP for a freestanding equity-linked instrument that does not meet the definition of a derivative and is not considered indexed to the reporting entity’s own stock. When the freestanding equity-linked instrument is a written option, and the reporting
entity is an SEC registrant, the reporting entity should consider the SEC guidance in ASC 815-10-S99-4.

**Excerpt from ASC 815-10-S99-4**

SEC staff’s longstanding position is that written options that do not qualify for equity classification initially should be reported at fair value and subsequently marked to fair value through earnings.

### 5.7 Reclassification of an instrument

ASC 815-40-35-8 provides guidance on the reassessment of instruments within the scope of ASC 815-40.

**ASC 815-40-35-8**

The classification of a contract 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.

Although ASC 480 addresses the reclassification of mandatorily redeemable shares, it does not require other liability contracts within its scope to be reassessed. Notwithstanding, we believe these liability contracts should be reassessed and reclassified if circumstances change. For example, if a redemption provision is eliminated from shares underlying a warrant (e.g., upon an IPO), the reporting entity should assess whether the warrant should be reclassified as equity. See FG 8.2.2.2 for information on warrants on redeemable shares.

ASC 815-40-35-9 and ASC 815-40-35-10 provide guidance on the reclassification of instruments within the scope of ASC 815-40. We believe this guidance should also be applied to contracts within the scope of ASC 480 that are reclassified due to a change in circumstances.

**ASC 815-40-35-9**

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.

**ASC 815-40-35-10**

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.

Reclassification of an instrument may occur when a new equity-linked instrument is issued and the reporting entity concludes that it does not have sufficient authorized and unissued shares to settle all
of its contracts. The determination of which instruments should be classified as equity will depend on the terms and policy for sequencing of instruments as discussed in FG 5.6.3.1.

If an equity-linked instrument classified as a liability is required to be reclassified to equity, the reporting entity should record the change in fair value of the liability through the date of reclassification in the income statement. Fair value on that date should be based on the fair value of the underlying shares.
Chapter 6: Convertible debt
6.1 Chapter overview

This chapter discusses the accounting for convertible debt, including the accounting treatment of modifications, conversion, and extinguishment of convertible debt.

Determining the appropriate accounting for convertible debt requires a detailed understanding of the instrument’s terms. It will typically require an evaluation of potential embedded derivatives and cash conversion features. The accounting literature that applies to convertible instruments can be difficult to navigate and apply.

6.2 Convertible instruments overview

Convertible instruments are debt or equity instruments that either require or permit the investor to convert the instrument into equity securities of the issuer. Some convertible instruments are convertible only upon the occurrence of a specified contingent event (e.g., upon an IPO).

An optionally convertible instrument is a debt or equity instrument that the investor has the option to (1) hold to maturity and redeem for par value, or (2) exercise the conversion option and receive shares. Convertible instruments are usually settled in the issuer’s common shares. If the conversion option is “in the money,” the shares are worth more than the par value of the instrument. Investors typically exercise the conversion option when it is in the money at (or close to) the instrument’s maturity date. Exercising the conversion option at an earlier date causes the investor to forfeit the remaining time value of the conversion option. Rather than early exercising a conversion option, investors looking to exit a convertible instrument often sell it to another investor that will pay for both the intrinsic and time value of the conversion option. If the issuer’s common stock price does not reach a level where the conversion option is in the money, the investor may decide not to exercise its option, the instrument will mature, and the investor will receive the par or stated value.

One of the key benefits to convertible instrument issuers is the relatively low cash coupon or dividend when compared to a similar nonconvertible instrument. The reduced interest rate is a result of the value of the conversion option. In other words, the issuer of a convertible instrument buys down the interest rate or dividend by selling the investor the conversion option embedded in the debt or equity host instrument.

See FG 7 for information on the accounting for convertible preferred stock.

6.3 Analysis of convertible debt

The accounting treatment for a convertible debt instrument depends on the terms of the instrument, including the manner in which the instrument is settled upon conversion. Some convertible debt instruments are settled upon conversion entirely in shares, some in a combination of cash and shares, and, less commonly, entirely in cash. The terms of the convertible debt instrument may mandate a settlement method or the reporting entity may have a choice.

In addition, many convertible debt instruments contain a number of provisions—such as put and call options or contingent interest features—that should be assessed to determine whether the features should be accounted for separately.
Figure 6-1 provides a framework for determining the appropriate accounting for the issuance of convertible debt.

**Figure 6-1**
Analysis of convertible debt

This framework will help a reporting entity determine which of the four accounting models it should follow when accounting for its convertible debt. Each is summarized in Figure 6-2.

**Figure 6-2**
Methods for accounting for convertible debt

<table>
<thead>
<tr>
<th>Method</th>
<th>Description of methodology</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Single instrument</strong></td>
<td>□ Record a liability equal to the proceeds received from issuance</td>
</tr>
<tr>
<td><em>(FG 1)</em></td>
<td>□ Amortize any discount or premium in the same manner as nonconvertible debt (see FG 1.2.3)</td>
</tr>
<tr>
<td></td>
<td>□ Account for derecognition as discussed in FG 3.7</td>
</tr>
<tr>
<td><strong>Derivative separation</strong></td>
<td>□ Determine the fair value of the embedded conversion option</td>
</tr>
<tr>
<td><em>(FG 6.5)</em></td>
<td>□ Record the conversion option at fair value and reduce the convertible debt liability by an equivalent amount</td>
</tr>
<tr>
<td>Method</td>
<td>Description of methodology</td>
</tr>
<tr>
<td>--------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td>□</td>
<td>Carry the conversion option as a liability at fair value with changes in fair value recorded in the income statement</td>
</tr>
<tr>
<td>□</td>
<td>Amortize any discount or premium in the same manner as nonconvertible debt (see FG 1.2.3)</td>
</tr>
<tr>
<td>□</td>
<td>Account for derecognition as discussed in FG 6.5.1</td>
</tr>
</tbody>
</table>

**Cash conversion option separation (FG 6.6)**

| □ | Determine the fair value of the debt liability by determining the fair value of an equivalent debt instrument without a conversion option |
| □ | The difference between the proceeds received and the debt liability is recorded in additional paid-in capital |
| □ | No subsequent remeasurement of the amount recorded in equity |
| □ | Amortize the discount on the debt liability to interest expense over the expected life of the debt instrument |
| □ | Account for derecognition as discussed in FG 6.5.1 |

**Beneficial conversion feature (BCF) separation (FG 6.7)**

| □ | Determine the BCF amount based on the in-the-money amount of the conversion option |
| □ | Record the BCF in additional paid-in capital and record a corresponding discount on the debt liability |
| □ | No subsequent remeasurement of the amount recorded in equity |
| □ | Amortize any discount or premium in the same manner as nonconvertible debt (see FG 1.2.3) |
| □ | Account for derecognition as discussed in FG 6.7.5 |

Convertible debt instruments that are separated into a debt and an equity component based on the guidance in ASC 470-20, *Debt with Conversion and Other Options*, such as debt with a cash conversion feature or beneficial conversion feature, are not eligible for the fair value option under ASC 825, *Financial Instruments*, based on the guidance in ASC 825-10-15-5(f). ASC 825-10-15-5(f) precludes application of the fair value option to financial instruments that are classified in whole or in part in equity. All other convertible debt instruments may be carried at fair value by the issuer, although this is typically not the case.

### 6.4 Analysis of the embedded conversion option

ASC 815, *Derivatives and Hedging*, provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative.
**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 this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

This guidance applies to conversion options (and other embedded components such as call and put options) embedded in convertible debt instruments. Many convertible debt instruments contain a conversion option with several settlement features that are interrelated. If, after performing the analysis of one settlement feature, it is determined that it should be separately accounted for as a derivative, then the entire conversion option should be separated and accounted for as a single derivative.

**6.4.1 Determining whether the conversion option is clearly and closely related to its host instrument**

When considering whether an embedded equity-linked component is clearly and closely related to its host instrument, a reporting entity should first determine whether the host is an equity host or a debt host. Instruments classified as debt, such as convertible debt instruments, are considered debt hosts. An embedded equity-linked component is generally not considered clearly and closely related to a debt host.

**6.4.2 Determining whether an embedded conversion option meets the definition of a derivative**

To determine whether a conversion option meets the definition of a derivative, its terms should be evaluated under the guidance in ASC 815-10-15-83. Typically, the criterion that determines whether a conversion option meets the definition of a derivative is the net settlement criterion. If the equity securities underlying the embedded conversion option are readily convertible to cash, such as publicly traded common shares, the embedded conversion option is likely to meet the net settlement criterion to be considered a derivative. If the equity securities underlying the conversion option are not readily convertible to cash, the embedded conversion option may not meet the net settlement criterion, and therefore would not meet the definition of a derivative. See FG 5.4.2 for further information on the concept of readily convertible to cash and DH 2 for further information on other forms of net settlement.

If an embedded conversion option meets the definition of a derivative, a reporting entity should assess whether it qualifies for the scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).
6.4.2.1 **Determining whether an embedded conversion option is eligible for the scope exception for contracts involving a reporting entity’s own equity**

ASC 815-10-15-74(a) provides a scope exception to the derivative accounting required under ASC 815, for certain contracts involving a reporting entity’s own equity.

**ASC 815-10-15-74(a)**

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
   2. Classified in stockholders’ equity in its statement of financial position.

An embedded component is considered indexed to a reporting entity’s own stock if it meets the requirements specified in ASC 815-40-15. See FG 5.6.2 for information on those requirements.

**Application to convertible debt**

To apply the requirements for equity classification to a conversion option embedded in a convertible debt instrument, the issuer should first determine whether the convertible debt instrument is considered “conventional.” ASC 815-40-25-39 describes a conventional convertible debt instrument as one “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).”

If convertible debt is considered conventional, the reporting entity only needs to consider the stated settlement alternatives (i.e., who controls the settlement and whether the settlement will be in shares or cash) to determine whether the embedded conversion option meets the requirements for equity classification. The additional requirements for equity classification in ASC 815-40-25-10 and ASC 815-40-55-2 through ASC 815-40-55-6 are not applicable. If the convertible debt instrument is not conventional, the reporting entity should consider all of the requirements for equity classification in ASC 815. See FG 5.6.2 and FG 5.6.3 for information on those requirements.

ASC 815-40-25-39 through ASC 815-40-25-41 explain the application of the criteria in ASC 815-40-25-10 to conventional convertible debt.

Question 6-1 discusses whether a convertible debt instrument that contains a “make-whole” provision is considered a conventional convertible debt instrument.
**Question 6-1**

Is a convertible debt instrument that provides for an adjustment to the number of shares deliverable upon conversion via a “make-whole” provision or table (i.e., a provision designed to compensate investors for unanticipated changes to the issuer as described further below), as is market standard practice, considered a conventional convertible debt instrument?

**PwC response**

No. Generally, an adjustment to the conversion option for anything other than standard anti-dilution provisions (e.g., adjustments for stock splits, rights offerings, dividends, or spin-offs) precludes a convertible debt instrument from being considered conventional. The fact that such a provision is standard practice is not relevant in determining whether an instrument is conventional as defined in ASC 815-40-25-39.

**Application to a contingent conversion option**

A contingent conversion option includes a contingency that determines whether the investor has the right to convert into equity (e.g., convertible only in the event of a successful IPO).

If a conversion option contingency is tied to an event (e.g., an IPO), the contingency does not affect whether the embedded component is considered indexed to the issuer’s stock. If a conversion option contingency is tied to an observable index, the contingency precludes the embedded component from being considered indexed to the issuer’s stock, unless the contingency is based on (1) the issuer’s stock price, or (2) a measure referencing the issuer’s operations (e.g., EBITDA).

If an instrument’s conversion is tied to achieving a substantive contingency based on an event or index other than the issuer’s stock price, the instrument should not be included in diluted earnings per share until the contingency has been met. See FSP 7.5.6.4 for information on earnings per share for contingently exercisable instruments and FSP 12.7 for balance sheet classification considerations applicable to contingently convertible debt.

**Application to a change in a conversion option upon a fundamental change**

Many convertible debt instruments provide for an adjustment to the number of shares deliverable if a fundamental change triggers an early conversion. In accordance with ASC 815-40-15-7D, if the number of shares used to calculate an instrument’s settlement amount is not fixed, it will still be considered indexed to a reporting entity’s own stock if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on equity shares (e.g., strike price, term, stock price volatility).

This provision is included primarily to compensate the investor for the time value of the option lost upon an unanticipated change, such as a change in control. Typically, the adjustment to the number of shares is included in a matrix of the issuer’s stock price and time to maturity. The number of shares to be received upon conversion decreases as the stock price increases and time to maturity decreases. However, because option time value is not linear, neither is the adjustment.

To determine whether this type of conversion option should be accounted for separately as a derivative, a reporting entity should consider whether it qualifies for the scope exception for contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).
The example in ASC 815-40-55-45 and ASC 815-40-55-46 (excerpted in the following section) concludes that a provision that uses a “make-whole” table to calculate the adjustment to the number of shares delivered upon conversion in the event of a fundamental change should be considered indexed to the reporting entity’s own stock because the number of shares delivered is determined based upon the issuer’s stock price and time to maturity, both of which are inputs to a fair value measurement of a fixed-for-fixed option on equity shares.

In addition, make-whole tables typically include a cap on the number of shares the reporting entity could be required to deliver upon conversion, which addresses one of the requirements for equity classification in ASC 815-40-25. Provided the remaining requirements for equity classification in ASC 815-40-25-10 are met, a conversion option which provides an adjustment to the number of shares delivered upon conversion in the event of a fundamental change would meet the requirements for the scope exception for contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

Convertible debt instruments often contain put options that allow investors to put the debt to the issuer (for par or some other stated amount) upon a fundamental change. Depending on the terms, such a put option may comprise both a traditional put right and a contingently exercisable conversion right, as discussed in Question 6-2. See FG 1.6.1 for information on evaluating put and call options embedded in debt instruments.

**Question 6-2**

Should an option that, in the event of a fundamental change, allows an investor to put a convertible debt instrument to the reporting entity for cash equal to the greater of (1) the par value of the debt instrument or (2) the converted value of the debt instrument be separated from the convertible debt instrument?

**PwC response**

Maybe. The put option upon a fundamental change is really two options (1) a put option at par value and (2) a contingently exercisable conversion option, which must be settled in cash.

The put option at par value needs to be evaluated to determine whether it should be separated (see FG 1.6.1).

The embedded conversion option should be separated. A conversion option that must be settled in cash in circumstances beyond the reporting entity’s control is not eligible for the scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a). Although the cash settlement provision is only included in the conversion option exercisable upon a fundamental change, if one settlement alternative fails to qualify for the scope exception, the entire conversion option should be separated and carried at fair value with changes in fair value recorded in the income statement.

**Application to a conversion option with a trading price condition (parity provision)**

Many convertible debt instruments with a contingent conversion option contain a provision that permits the investor to exercise the conversion option if the debt instrument is trading below a specified percentage, for example 98% of the parity value of the underlying shares (referred to as a “parity provision”). This provision is typically included to provide protection to the investor by allowing conversion in a scenario when they may want to convert, but would be unable to do so
because the trigger for the contingent conversion has yet to be met. Theoretically, a convertible debt instrument should always be worth more than the underlying shares because a convertible debt instrument provides a floor on the value to be received (absent an event involving the credit of the reporting entity, the investor will receive at least the par value of the debt instrument at maturity) as well as coupon payments over the life of the debt instrument. A parity provision is likely to only be triggered in periods of extreme market disruption that impact the value of the convertible debt instrument and shares.

To determine whether a conversion option with a parity provision should be separated and accounted for as a derivative, a reporting entity should consider whether it qualifies for the scope exception for contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

**ASC 815-40-55-45**

This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. 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:

a. Entity A’s stock price exceeds $13 per share (market price trigger).

b. The convertible debt instrument trades for an amount that is less than 98 percent of its if-converted value (parity provision).

c. There is an announcement of a merger involving Entity A.

**ASC 815-40-55-46**

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.
As described above, if the requirements for equity classification in ASC 815-40-25 are met, a parity provision typically meets the requirements for the scope exception for contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

**Application to debt convertible into stock of a consolidated subsidiary**

In the consolidated financial statements, debt that is convertible into the stock of a substantive consolidated subsidiary (whether the convertible debt is issued by the parent or the subsidiary) should be accounted for in the same manner as debt that is convertible into the parent company’s stock. The same is not true for instruments indexed to the stock of an affiliate that is not a consolidated subsidiary or to the stock of an equity-method investee. The stock of an affiliate or equity-method investee is not considered the reporting entity’s own stock.

See FG 5.6.2.4 for information on instruments indexed to the stock of a subsidiary or affiliate.

**Application to instruments convertible into a variable number of shares**

A debt instrument that can be settled by delivery of a variable number of shares should be evaluated to determine whether the embedded conversion option is in substance, a put option (redemption feature) designed to provide the investor with a fixed monetary amount, settleable in shares. For example, a reporting entity may issue a debt instrument that converts, either automatically or at the issuer’s option, into a variable number of shares upon the completion of a capital raising transaction. The number of shares received is determined by dividing the instrument’s outstanding principal and accrued interest balance by the fair value of the shares. This feature is in substance a put option, which should be evaluated under the guidance in ASC 815 to determine whether the put option should be separated and accounted for as a derivative. Oftentimes, the formula used to calculate the number of shares to be delivered will result in settlement of the convertible debt instrument at a premium. See FG 1.6.1 for information on evaluating put and call options embedded in debt instruments.

**6.5 Convertible debt with a separated conversion option**

When a reporting entity concludes that a conversion option should be separated from its host debt instrument and accounted for as a derivative, it should be accounted for as a freestanding derivative instrument under the guidance in ASC 815. That is, classified on the balance sheet as a derivative liability at fair value with any changes in its fair value recognized currently in the income statement. The host contract should be accounted for using the guidance applicable to nonconvertible debt.

ASC 815-15-30-2 through ASC 815-15-30-6 provide guidance on allocating the carrying amount of a hybrid instrument between the host contract and the derivative. That guidance requires the derivative to be initially measured at fair value, with the host contract carried at a value equal to the difference between the previous carrying amount of the hybrid instrument and the fair value of the derivative. Therefore, there is no gain or loss from the initial recognition and measurement of an embedded derivative that is accounted for separately from its host contract. When the embedded derivative is an option, ASC 815-15-30-6 requires it to be separated and recorded at its fair value based on its stated contract terms. The allocation of proceeds to the separated derivative will typically create a discount or premium on the associated host debt instrument.
6.5.1 Derecognition of convertible debt with a separated conversion option

When a conversion feature has been separated from a convertible debt instrument and accounted for as a derivative liability, there is no equity conversion feature remaining in the debt for accounting purposes. Therefore, while there may be a legal conversion of the debt, for accounting purposes we believe that both liabilities (i.e., the debt host and the separated derivative liability) should be subject to extinguishment accounting, because they are being surrendered in exchange for common shares. As such, a gain or loss upon extinguishment of the two liabilities equal to the difference between the recorded value of the liabilities and the fair value of the consideration issued to extinguish them should be recorded.

To account for the conversion of a convertible instrument when the conversion option has been separated and accounted for as a derivative liability, a reporting entity should perform the following steps:

- Update the valuation of the separated conversion option to the date the instrument is legally converted.
- Adjust the carrying amount of the host debt instrument to reflect amortization of any premium or discount associated with the host debt instrument up to the date the instrument is legally converted.
- Amortize debt issuance costs to the date the instrument is legally converted.
- Ensure that the carrying amount of the host debt instrument reflects all components of book value, including the unamortized portion of any premiums or discounts on the debt host recorded as an adjustment to the debt host and any unamortized debt issuance costs. These items collectively represent the net carrying amount of the debt host used to measure the extinguishment gain or loss.
- Calculate the difference between the reacquisition price and the net carrying amount of the debt by comparing the fair value of the consideration (i.e., cash and shares) issued upon conversion to the sum of the updated net carrying amounts of the (1) separated conversion option liability and (2) debt host. Record any difference as an extinguishment gain or loss in the income statement.

When updating the valuation of the separated conversion option to the date the instrument is legally converted, reporting entities may adjust the separated conversion option to either its intrinsic value or fair value as of the conversion date. Adjusting the separated conversion option to its intrinsic value reflects the investor's decision to truncate the term of the option by exercising it early. The foregone time value is recorded as part of the change in fair value of the derivative liability recorded in the income statement, rather than as part of the extinguishment transaction. Adjusting the separated conversion option to its fair value allocates the time value foregone by the investor to the gain or loss on extinguishment, rather than the change in the fair value of the derivative liability. Under either approach, the total income statement impact is the same.

Example 6-1 illustrates how to account for the derecognition of a convertible debt instrument with a separated conversion option.
**EXAMPLE 6-1**

Derecognition of convertible debt with a separated conversion option

FG Corp issues convertible debt that will be settled upon conversion entirely in cash. FG Corp concludes that the embedded conversion option should be separated from the debt and accounted for as a derivative liability under the guidance in ASC 815. The host debt instrument is accounted for as a liability.

FG Corp determines the fair value of the embedded conversion option to be $200.

FG Corp’s stock price is $85 at the date the convertible debt is issued. The debt is issued at par and for this example, there are no debt issuance costs.

The convertible debt has the following terms:

<table>
<thead>
<tr>
<th>Principal amount</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coupon rate</td>
<td>5% paid semi-annually on June 30 and December 31</td>
</tr>
<tr>
<td>Years to maturity</td>
<td>5 years</td>
</tr>
<tr>
<td>Conversion price</td>
<td>$100</td>
</tr>
<tr>
<td>Number of shares underlying conversion option</td>
<td>10</td>
</tr>
</tbody>
</table>

One year after FG Corp issues the convertible debt, investors exercise their conversion options when the stock price is $110. FG Corp delivers $1,100 in cash ($110 current stock price multiplied by 10 shares underlying the conversion option) to investors.

The fair value of the embedded conversion option is $380 at the conversion date, one year after issuance and prior to exercise.

How should FG Corp record (1) issuance of the convertible debt and (2) conversion of the convertible debt?

**Analysis**

To recognize the conversion option (at fair value of $200) and the debt host contract (remaining proceeds) upon issuance of the convertible debt, FG Corp should record the following journal entry.

Dr. Cash $1,000
Cr. Debt host instrument $800
Cr. Derivative liability (separated conversion option) $200

At the end of the first year, FG Corp should (1) update the valuation of the separated conversion option to its fair value of $380 and (2) amortize the debt discount by recording the following journal entry.
Convertible debt

<table>
<thead>
<tr>
<th>Dr. Loss on derivative liability</th>
<th>$180</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Interest expense (amortization of discount)</td>
<td>$40</td>
</tr>
<tr>
<td>Cr. Debt host instrument</td>
<td>$40</td>
</tr>
<tr>
<td>Cr. Derivative liability (separated conversion option)</td>
<td>$180</td>
</tr>
</tbody>
</table>

To derecognize the host debt instrument and separated conversion option upon conversion, FG Corp should record the following entries.

First, FG Corp should adjust the value of the separated conversion option. Management elects to adjust the value to its intrinsic value of $100 at the conversion date (stock price of $110 less the conversion price of $100 multiplied by 10 shares). As noted above, adjusting the separated conversion option to its fair value would also have been acceptable.

| Dr. Derivative liability (separated conversion option) | $280 |
| Cr. Gain on derivative liability | $280 |

Next, FG Corp should extinguish the debt host instrument and derivative liability and recognize a loss on extinguishment.

| Dr. Debt host instrument | $840 |
| Dr. Derivative liability (separated conversion option) | $100 |
| Dr. Loss on debt extinguishment | $160 |
| Cr. Cash | $1,100 |

6.5.2 Accounting when a conversion option separated from convertible debt is reclassified

ASC 815-15-35-4 provides guidance that addresses a reporting entity’s accounting for a previously separated conversion option that no longer meets the criteria for separate accounting.

**ASC 815-15-35-4**

If an embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in this Subtopic, an issuer shall account for the previously bifurcated conversion option by reclassifying the carrying amount of the liability for the conversion option (that is, its fair value on the date of reclassification) to shareholders’ equity. Any debt discount recognized when the conversion option was bifurcated from the convertible debt instrument shall continue to be amortized.

ASC 815-15-40-1 and ASC 815-15-40-4 address a reporting entity’s accounting upon conversion or extinguishment of an instrument which has previously been separated.
ASC 815-15-40-1

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.

ASC 815-15-40-4

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:

a. 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.

b. The remaining reacquisition price shall be allocated to the extinguishment of the debt to determine the amount of gain or loss.

ASC 815-15-50-3 requires a reporting entity to disclose (1) a description of the principal changes causing the embedded conversion option to no longer require separate accounting and (2) the amount of the liability for the conversion option reclassified to stockholder’s equity.

6.6 Convertible debt with a cash conversion feature

In traditional, share-settled convertible debt, no cash is received upon conversion. If the investor exercises its conversion option, the full number of shares underlying the debt instrument is received. In contrast, a convertible debt instrument with a cash conversion feature allows, or requires, the reporting entity to settle its obligation upon conversion, in whole or in part, in a combination of cash or stock at the investor or issuers’ option or mandatorily. ASC 470-20 provides specific accounting guidance for convertible debt instruments with a cash conversion feature provided the conversion option is not separated under the guidance in ASC 815-15-25-1. See FG 6.4 for information on when a conversion option should be separated from its host debt instrument.

If convertible debt with a cash conversion feature contains an embedded derivative other than the embedded conversion option (e.g., a change in control put option), that embedded derivative should be evaluated under the guidance in ASC 815 to determine whether it should be accounted for separately before the guidance in ASC 470-20 is applied. Therefore, when evaluating whether an embedded put or call option should be accounted for separate from the host debt instrument, the discount created by separating the conversion option under the guidance in ASC 470-20 should not be considered. See FG 1.6.1 for information on embedded put and call options in debt instruments and FG 6.10.1 for information on contingent interest features.

Question 6-3 discusses if a reporting entity should apply the cash conversion guidance in ASC 470-20 to convertible debt instrument that permits the reporting entity to settle a portion of its debt in cash upon conversion, if it does not intend to use the cash conversion alternative.
Question 6-3
Should a reporting entity apply the cash conversion guidance in ASC 470-20 to a convertible debt instrument that permits the reporting entity to settle a portion of its debt in cash upon conversion if it does not intend to use the cash conversion alternative?

PwC response
Yes. We believe that the scoping language of the cash conversion subsection of ASC 470-20 is intentionally broad. Any instrument with the possibility of partial cash settlement (or settlement in other assets), even for a small portion of the total conversion value, and regardless of intent to cash settle, should be accounted for using this guidance.

ASC 470-20-15-5 provides exceptions to the scope of the cash conversion guidance.

ASC 470-20-15-5
The Cash Conversion Subsections do not apply to any of the following instruments:

a. A convertible preferred share that is classified in equity or temporary equity.

b. A convertible debt instrument that requires or permits settlement in cash (or other assets) upon conversion only in specific circumstances in which the holders of the underlying shares also would receive the same form of consideration in exchange for their shares.

c. A convertible debt instrument that requires an issuer’s obligation to provide consideration for a fractional share upon conversion to be settled in cash but that does not otherwise require or permit settlement in cash (or other assets) upon conversion.

Although ASC 470-20-15-5 exempts equity-classified convertible preferred shares from the cash conversion guidance in ASC 470-20, the guidance does apply to convertible preferred shares that are classified as liabilities for financial reporting purposes.

6.6.1 Initial measurement and recognition
Convertible debt with a cash conversion feature should be separated into a debt component and an equity component. This is done by:

- Determining the carrying amount of the debt component based on the fair value of a similar debt instrument excluding the embedded conversion option. Typically, an income valuation approach, or a present value calculation, is used to calculate the fair value of the debt liability. To perform this calculation, the issuer should determine (1) the expected life of the debt (see FG 6.6.1.1 for further information), and (2) the borrowing rate of a nonconvertible debt instrument (see FG 6.6.1.2 for further information)

- Recognizing the equity component by ascribing the difference between the proceeds and the fair value of the debt liability to additional paid-in capital

- Reporting the difference between the principal amount of the debt and the amount of the proceeds allocated to the debt component as a debt discount, which is subsequently amortized through interest expense over the instrument’s expected life using the interest method
Convertible debt instruments that are separated into a debt and equity component in accordance with the guidance in ASC 470-20 are not eligible for the fair value option under ASC 825, based on the guidance in ASC 825-10-15-5(f). ASC 825-10-15-5(f) precludes application of the fair value option to financial instruments that are, in whole or in part, classified in equity by a reporting entity.

Issuance costs should be allocated to the debt and equity components in proportion to the allocation of proceeds to those components. Allocated costs should be accounted for as debt issuance costs (capitalized and amortized to interest expense using the interest method) and equity issuance costs (charged to equity), respectively.

### 6.6.1.1 Determining the expected life

To calculate the fair value of convertible debt exclusive of its embedded conversion option, an issuer should estimate the instrument’s expected life. When determining the expected life, all substantive embedded features, other than the embedded conversion option, should be considered. ASC 470-20-30-30 provides guidance on whether an embedded feature is nonsubstantive.

#### ASC 470-20-30-30

Solely for purposes of applying the initial measurement guidance in paragraphs 470-20-30-27 through 30-28 and the subsequent measurement guidance in paragraph 470-20-35-15, an embedded feature other than the conversion option (including an embedded prepayment option) shall be considered nonsubstantive if, at issuance, the entity concludes that it is probable that the embedded feature will not be exercised. That evaluation shall be performed in the context of the convertible debt instrument in its entirety.

An issuer should consider the effect of any prepayment features, such as put and call options, on the expected life of the debt liability. The method of determining the expected life of a debt liability with puts and calls described in ASC 470-20 is to consider whether it would be rational to exercise a call (or for the investor to exercise a put) if it were embedded in a nonconvertible debt instrument with the same terms as the convertible debt instrument being evaluated. The hypothetical nonconvertible debt instrument is an instrument that (1) pays the same coupon rate as the convertible debt instrument and (2) was issued at a discount to par value, to compensate for the low coupon rate when compared to nonconvertible debt rates.

When considering puts and calls embedded in debt instruments:

- A borrower would generally not call a nonconvertible debt instrument at par with a low coupon and issued at a significant discount. Therefore, such a nonconvertible debt instrument generally has an expected life equal to its contractual life.

- Conversely, an investor would generally put a nonconvertible debt instrument with a low coupon and issued at a significant discount back to the borrower as soon as possible. Therefore, a debt instrument which the investor can put back to the issuer generally has an expected life from the issuance date to the first put date.

- A debt instrument which the reporting entity can call and the investor can put on the same date generally has an expected life equal to the period from issuance to the simultaneous put and call date.
Figure 6-3 provides a summary of the likely effect of put and call options on the estimated life of the convertible debt liability.

**Figure 6-3**
Summary of likely effect of puts and calls on the estimated life of a nonconvertible debt instrument

<table>
<thead>
<tr>
<th>Description</th>
<th>Likely estimated life</th>
</tr>
</thead>
</table>
| Matures in 10 years  
Issuer call in 5 years  
Investor put in 5 years | 5 years |
| Matures in 10 years  
Issuer call in 5 years  
Investor put in 7 years | 7 years |
| Matures in 10 years  
Issuer call in 7 years  
Investor put in 5 years | 5 years |
| Matures in 10 years  
No issuer call  
Investor put in 5 years | 5 years |
| Matures in 10 years  
Issuer call in 5 years  
No investor put | 10 years |

The expected life should not be reassessed in subsequent reporting periods.

Question 6-4 discusses if an issuer should consider the effect of a feature that allows an investor to put a debt instrument upon a fundamental change when determining the expected life of a convertible debt instrument within the scope of the cash conversion guidance in ASC 470-20

**Question 6-4**

Should an issuer consider the effect of a feature that allows an investor to put a debt instrument upon a fundamental change (commonly referred to as a change-in-control put option) when determining the expected life of a convertible debt instrument within the scope of the cash conversion guidance in ASC 470-20?

**PwC response**

Perhaps. The issuer should assess whether the change in control put is a substantive feature at the issuance date. If, at issuance, it is probable that an event that will trigger the change in control put will *not* occur, the change in control put should be deemed non-substantive and disregarded for purposes of determining the expected life. However, if the change-in-control put option is considered substantive, its effect should be considered when determining the expected life.
Figure 6-3 illustrates a literal application of the guidance in ASC 470-20 on determining the expected life of a debt instrument. Following this guidance can produce anomalous results. For example, applying the guidance to a convertible debt instrument with a contractual life of ten years that is puttable by the investor in year five will result in an expected life of five years. In that case, the issuer should amortize the discount created by separating the debt into its components over five years; however, investors will likely leave the debt outstanding for the full ten years because they will consider the value of the conversion option. This will result in an above market interest expense (equal to the coupon in the convertible debt and the amortization of the discount created by separating the debt into its components) over the first five years and a below market interest expense (equal to the coupon on the convertible debt) over the last five years. Because the original intent of this guidance was to produce a market rate of interest on the debt, we question whether this was the intended result. For that reason we have accepted an analysis of expected life that is more consistent with the economics of the instrument. However, notwithstanding these anomalous results, we believe applying the guidance literally is an acceptable approach.

6.6.1.2 Determining the nonconvertible debt rate

To determine the interest rate of a similar nonconvertible debt instrument, an issuer should first consider the interest rate on its own nonconvertible debt. If that debt is similar to the convertible debt being evaluated, in terms of issuance date, tenor, and seniority, it may be appropriate to use the interest rate on its own nonconvertible debt without making any adjustments to it. If there are differences in issuance date, tenor, or seniority, an issuer should consider these differences in determining the nonconvertible debt rate.

If the issuer does not have similar nonconvertible debt, it should consider market rates for nonconvertible debt instruments with terms similar to the convertible debt being evaluated that have been issued by companies with similar credit quality to the issuer.

A reporting entity may want to consider the use of a valuation specialist to help determine the interest rate for similar nonconvertible debt instruments. This is especially true for high-yield issuers who may not have sufficient market data regarding nonconvertible debt rates available due to low credit quality.

6.6.2 Subsequent accounting

As discussed in FG 6.6.1, convertible debt with a cash conversion feature should be separated into a debt component and an equity component. FG 6.6.2.1 and FG 6.6.2.2 provide information on the amortization of the resulting debt discount and subsequent measurement requirements for a separated equity component.

6.6.2.1 Amortization of debt discount

The discount created by separating the convertible debt instrument into its debt and equity components should be amortized using the interest method. The amortization period should be the expected life of a similar nonconvertible debt instrument (considering the effects of any embedded features other than the conversion option, such as prepayment options). See FG 6.6.1.1 for information on determining the expected life. The amortization period is not reassessed in subsequent reporting periods.
Periodic reported interest expense for convertible debt with a cash conversion feature includes (1) the instrument’s coupon and (2) the current period’s amortization of the debt discount. Therefore, the accounting interest expense will be higher than the cash coupon on the convertible debt.

Question 6-5 discusses how a reporting entity should record interest expense on convertible debt with a cash conversion period if it remains outstanding after the debt discount amortization period.

**Question 6-5**

A reporting entity issues convertible debt with a cash conversion feature with a term of seven years. The reporting entity decides to amortize the discount created by separating its convertible debt instrument over a period of five years because the debt is puttable by investors at the end of the fifth year.

The put is not exercised and the debt remains outstanding after five years. How should the reporting entity record interest expense on the convertible debt instrument in years six and seven?

**PwC response**

Once the debt discount recorded at issuance has been fully amortized, the reporting entity should record only the cash coupon on the convertible debt as interest expense. ASC 470-20 does not permit adjustments to the amortization period or expected life of a convertible debt instrument after issuance.

**6.6.2.2 Subsequent measurement of equity component**

The separated equity component should not be remeasured, provided it continues to meet the requirements for equity classification (i.e., it does not have to be accounted for as a derivative under the guidance in ASC 815). See FG 5.6.3 for further information.

**Temporary (mezzanine) equity classification**

SEC registrants should present some portion of the separated equity component as temporary (or mezzanine) equity in periods in which the instrument is convertible or redeemable for cash or other assets. The amount recorded in temporary equity is equal to the amount of cash (or other assets) an investor would receive upon conversion or redemption less the amount of liability recorded for the debt component.

ASC 480-10-S99-3A provides guidance on when an instrument is considered convertible or redeemable for cash or other assets.

- Debt is currently convertible if the investor is able to exercise its conversion option and require the reporting entity to settle in cash or other assets. For contingently convertible debt, this would typically be the case if, at the balance sheet date, the contingency has been met. For debt without a conversion contingency, the debt may be convertible at any time.

- Debt is currently redeemable if (1) the investor holds a put option that is currently exercisable for cash or other assets or (2) the debt instrument matures in the current period.

Question 6-6 addresses whether some portion of an immediately convertible cash conversion bond should be recorded as temporary equity.
**Question 6-6**

FG Corp issues an immediately convertible cash conversion bond with a principal amount of $1,000. Based on the guidance in ASC 470-20, FG Corp determines that the bond should be separated into a $700 debt liability and a $300 equity component. Should FG Corp record some portion of the $300 equity component as temporary equity?

**PwC response**

Yes. At issuance, FG Corp should record $300 of the equity component as temporary equity. Since the bond is immediately convertible, FG Corp could be required to deliver $1,000 of cash to the investor if they immediately convert; therefore, FG Corp should have a combined liability and temporary equity balances equal to $1,000. As FG Corp accretes the liability balance over time (in accordance with the guidance in ASC 470-20), it should reclassify a portion of the temporary equity balance to permanent equity such that the combined liability and temporary equity balances remain equal to $1,000.

Although technically not required for private entities, mezzanine equity presentation is strongly encouraged, especially in those circumstances where there is not a high likelihood that the capital is in fact permanent. If mezzanine presentation is not elected, separate presentation from other items within equity should be considered.

6.6.3 *Earnings per share*

Most cash conversion debt instruments are included in diluted earnings per share using a method similar to the treasury stock method described in ASC 260, *Earnings per Share*. (ASC 260-10-55-84 through ASC 260-10-55-84B provide an illustration of the treasury stock method). However, when determining the earnings per share treatment of a debt instrument that may settle in any combination of cash or stock at the issuer’s option, an issuer should consider the guidance on instruments settleable in cash or shares. See FSP 7.5.6.3 for information on the earnings per share treatment of cash conversion debt instruments and FSP 7.5.7.1 for information on instruments settleable in cash or shares.

6.6.4 *Application example*

Example 6-2 illustrates the initial recognition and measurement and subsequent accounting of convertible debt with a cash conversion feature.

**EXAMPLE 6-2**

Accounting for convertible debt with a cash conversion feature

FG Corp issues convertible debt that will be settled upon conversion by delivering (1) cash up to the principal amount of the debt instrument and (2) net shares equal to any value due to the conversion option being in the money. FG Corp’s stock price is $85 at the date the convertible debt is issued.
The convertible debt has the following terms:

<table>
<thead>
<tr>
<th>Principal amount</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coupon rate</td>
<td>2%</td>
</tr>
<tr>
<td>Years to maturity</td>
<td>7 years</td>
</tr>
<tr>
<td>Issuer call option</td>
<td>2 years and thereafter</td>
</tr>
<tr>
<td>Investor put option</td>
<td>5 years and thereafter</td>
</tr>
<tr>
<td>Conversion Price</td>
<td>$100</td>
</tr>
<tr>
<td>Conversion terms</td>
<td>Investors can convert in any quarter following a quarter in which FG Corp’s stock price traded at or above $110 for at least 45 days</td>
</tr>
<tr>
<td>Conversion settlement</td>
<td>Upon conversion, the investor will receive $1,000 in cash and net shares equal to any value due to the conversion option being in the money</td>
</tr>
</tbody>
</table>

FG Corp concludes that the debt instrument is within the scope of the cash conversion guidance in ASC 470-20 and should be separated into its debt and equity components.

FG Corp determines that a nonconvertible debt instrument with the same terms would have an expected life of five years because its debt instrument is puttable by investors at the beginning of year six. Based on its analysis of 5-year nonconvertible debt with similar terms issued by companies with similar credit quality, FG Corp determines the coupon rate for a nonconvertible debt instrument with the same terms to be 8.02%. Using a present value calculation, FG Corp determines the initial carrying value of the debt to be $760. The proceeds allocated to the equity component is therefore $240 (the difference between the $1,000 proceeds and $760 debt liability).

FG Corp develops the following schedule of balances and amortization using the beginning debt liability balance calculated using an income valuation approach and the interest method of amortization.

This example ignores the effects of income taxes.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at beginning of period</td>
<td>$760</td>
<td>$801</td>
<td>$845</td>
<td>$893</td>
<td>$944</td>
</tr>
<tr>
<td>Amortization of discount</td>
<td>41</td>
<td>44</td>
<td>48</td>
<td>52</td>
<td>56</td>
</tr>
<tr>
<td>Balance at end of period</td>
<td>$801</td>
<td>$845</td>
<td>$893</td>
<td>$944</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

How should FG Corp record (1) the issuance of its convertible debt instrument and (2) amortization of the debt discount and payment of interest during the first year the debt is outstanding?
**Analysis**

To recognize the receipt of cash and separation of the convertible debt instrument into its debt liability and residual equity components, FG Corp should record the following journal entry.

- Dr. Cash $1,000
- Dr. Convertible debt discount $240
- Cr. Convertible debt $1,000
- Cr. Additional paid-in capital (conversion option) $240

To recognize the amortization of the debt discount and payment of interest during the first year the debt is outstanding, FG Corp should record the following journal entry.

- Dr. Interest expense $61
- Cr. Cash $20
- Cr. Convertible debt discount $41

**6.6.5 Derecognition (conversion or extinguishment)**

The accounting for the derecognition of convertible debt with a cash conversion feature is the same whether the debt instrument is extinguished (repurchased) or converted. In either case, the reporting entity should allocate the fair value of the consideration transferred (cash or shares) and any transaction costs incurred between (1) the debt component—to reflect the extinguishment of the debt and (2) the equity component—to reflect the reacquisition of the embedded conversion option.

An issuer should first calculate the fair value of the debt immediately prior to its derecognition. This is generally done by re-calculating the carrying value of the debt instrument using an updated remaining expected life of the debt instrument and an updated nonconvertible debt rate assumption. A gain or loss on extinguishment equal to the difference between the calculated fair value of the debt immediately prior to its derecognition and the carrying amount of the debt component, including any unamortized debt discount or issuance costs, is recorded in the income statement.

The remainder of the consideration is allocated to the reacquisition of the equity component.

If any other stated or unstated rights and privileges exist, a portion of the consideration should be allocated to those rights and privileges and accounted for according to other applicable accounting guidance.

See FG 6.9.1.2 for information on induced conversions of cash conversion debt.

Example 6-3 illustrates the derecognition of a convertible debt with a cash conversion feature.
EXAMPLE 6-3
Derecognition of a convertible debt with a cash conversion feature

This example is a continuation of Example 6-2.

Three years after the issuance of its convertible debt instrument, FG Corp decides to exercise its call option. FG Corp’s stock price is $125 on the date it calls its convertible debt.

Once the debt instrument is called by FG Corp, investors can either (1) convert the debt instrument and receive cash and shares with a value equal to $1,250, which is the instrument’s conversion value, or (2) choose not to convert and receive $1,000 upon settlement of the call option. Investors choose to convert their debt instruments. FG Corp delivers $1,000 in cash and 2 shares (worth $125 each) for total consideration of $1,250.

FG Corp determines that the updated expected life of the debt instrument is equal to the remaining original expected life of the debt instrument, which is two years. Based on its analysis of 5-year nonconvertible debt with two years left to maturity with similar terms issued by companies with similar credit quality, FG Corp determines the coupon rate for a nonconvertible debt instrument with the same terms to be 6.1%.

Using a present value calculation, FG Corp determines the fair value of the debt component to be $925.

FG Corp allocates the $1,250 consideration transferred to investors as follows (1) $925 to extinguish the debt and (2) $325 to reacquire the embedded conversion option.

A loss on extinguishment of $32 is determined by calculating the difference between (1) the fair value of the debt component prior to conversion—$925 and (2) the carrying value of the debt instrument at the end of year three—$893 (see table in Example 6-2).

FG Corp’s common stock has a $1.00 par value.

This example ignores the effects of income taxes.

How should FG Corp record the conversion by investors?

Analysis

FG Corp should record the following journal entry.

<table>
<thead>
<tr>
<th>Dr. Convertible debt</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Additional paid-in capital (conversion option)</td>
<td>$325</td>
</tr>
<tr>
<td>Dr. Loss on extinguishment of convertible debt</td>
<td>$32</td>
</tr>
<tr>
<td>Cr. Convertible debt discount</td>
<td>$107</td>
</tr>
<tr>
<td>Cr. Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>Cr. Common stock–par value</td>
<td>$2</td>
</tr>
<tr>
<td>Cr. Additional paid-in capital (common stock)</td>
<td>$248</td>
</tr>
</tbody>
</table>
6.7 Beneficial conversion features

A convertible debt instrument may contain a beneficial conversion feature (BCF) or contingent BCF if the conversion option is not accounted for separately. Given the number of convertible debt instruments that have separated conversion options (under the guidance in ASC 470 and ASC 815), it is unusual for a convertible debt instrument to have a BCF.

The ASC Master Glossary provides the definition of a beneficial conversion feature.

**Definition from ASC Master Glossary**

Beneficial Conversion Feature: A nondetachable conversion feature that is in the money at the commitment date.

A convertible instrument contains a BCF when the conversion price is less than the fair value of the shares into which the instrument is convertible at the commitment date. See FG 7.3.2.2 for information on determining the commitment date and conversion price used to assess whether a convertible instrument contains a BCF. FG 7.3.2.2 also provides information on contingent BCFs.

6.7.1 Resetting a conversion option for a change in stock price

Some convertible instruments pay a fixed monetary amount to the investor upon conversion. To do this, the instrument’s conversion price is adjusted for increases or decreases in the fair value of the reporting entity’s stock. ASC 470-20-55-19 provides guidance for these instruments, which are in substance, stock-settled debt.

**ASC 470-20-55-19**

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, there is no beneficial conversion option and the convertible instrument would be considered stock-settled debt. However, if the conversion price does not fully reset (for example, resets on specified dates before maturity), the reset represents a contingent beneficial conversion feature subject to this Subtopic.

A reporting entity should assess the reset terms of its convertible instrument to determine whether it is stock-settled debt or a convertible instrument with a contingent BCF.

6.7.2 Measurement and recognition

A BCF is measured as the intrinsic value of the conversion option at the commitment date, representing the difference between the conversion price and the reporting entity’s stock price on the commitment date.

A BCF should be separated from a convertible instrument and recorded in additional paid-in capital. SEC registrants should present the BCF as mezzanine equity in periods in which it is redeemable, as described in ASC 480-10-S99-3A. The amount recorded in temporary equity is equal to the amount of
cash an investor would receive upon redemption less the amount of liability recorded for the debt component.

**Excerpt from ASC 480-10-S99-3A**

...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).

Although technically not required for nonpublic entities, mezzanine equity presentation is strongly encouraged, especially in those circumstances where there is not a high likelihood that the capital is in fact permanent, for example when the instrument is redeemable at the option of the holder at any time. On the other hand, use of a mezzanine presentation may be considered less relevant in other circumstances, such as when an instrument is redeemable by the holder only upon a remote event. If mezzanine presentation is not elected, separate presentation from other items within equity should be considered.

Separating a BCF will create a discount in the convertible debt that will result in additional interest expense.

### 6.7.3 Amortization of the discount created by separating a BCF

The discount on the convertible debt instrument created by separating a BCF, or contingent BCF, should be amortized over the period from the issuance date to the stated maturity date using the effective interest method; the amortization should be recognized as interest cost.

If the convertible debt is puttable by the investor prior to the first conversion date, we believe amortization of a discount created by separation of a BCF may be amortized over the period (1) from the issuance date to that first conversion date, or (2) from the issuance date to the first put date. A reporting entity should elect one of these options as an accounting policy and apply it consistently.

If a BCF is recorded on a convertible instrument with a multi-step discount, the amount of amortization recorded may require periodic adjustment to ensure that the BCF amount is at least equal to the intrinsic value the investor could realize if the instrument were converted at that point in time. See FG 7.3.2.2 for information on convertible instruments with multiple-step discounts.

### 6.7.4 Conversion of convertible debt with a BCF

ASC 470-20-40-1 requires a reporting entity to recognize any unamortized discount resulting from the separation of a BCF upon conversion of the instrument as interest expense. Any other unamortized discounts (e.g., created by allocating proceeds to warrants issued with the convertible instrument) should also be recognized as interest expense upon conversion. In accordance with ASC 470-20-40-2, if the amount of BCF discount amortized exceeds the amount the holder realized because conversion occurred at an earlier date, no adjustment should be made to amounts previously amortized. This guidance is unique to convertible instruments containing a BCF and should not be applied to other convertible instruments.

If a convertible instrument with a multiple-step discount is converted at a point in time when the conversion price on that date is less beneficial than the conversion price used to initially record the
BCF, any previously recognized amortization of the discount created by separating the BCF should not be reversed. See FG 7.3.2.2 for information on BCFs with a multiple-step discount.

6.7.5  **Extinction or redemption of convertible debt with a BCF**

ASC 470-50-40-2 provides guidance on how to calculate a gain or loss on debt extinguishment.

**Excerpt from ASC 470-50-40-2**

A difference between the reacquisition price 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.

The net carrying amount of debt includes any unamortized discount created by separating a BCF.

In addition to derecognizing the debt instrument, the reporting entity should derecognize the BCF as well. To do this, the reporting entity should perform the following steps.

- Calculate the intrinsic value (i.e., the in-the-money amount) of the conversion option at the extinguishment date and allocate that amount to additional paid-in capital to redeem the BCF
- Allocate the remainder of the reacquisition price to the extinguishment of the debt and record a gain or loss on debt extinguishment by comparing the reacquisition price allocated to the debt with the net carrying amount of the debt

See FG 3.7 for further information on debt extinguishment accounting.

6.8  **Modification of convertible debt**

For convertible debt, the test to determine whether a debt modification or extinguishment has occurred is more complicated than the 10% test described in FG 3.4. ASC 470-50-40-10 prescribes a two-step approach for determining whether a convertible debt modification should be accounted for as a modification or an extinguishment.

**ASC 470-50-40-10**

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 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.)

ASC 470-50-40-10 does not address legal modifications or exchanges of debt instruments in which the embedded conversion option is separated and accounted for as a derivative under ASC 815 prior to modification, subsequent to modification, or both. The accounting for these transactions depends on the specific facts and circumstances.

6.8.1 Test to determine how to account for a modification or exchange

To determine whether a modification or exchange of a convertible debt instrument should be accounted for as a modification or an extinguishment, a reporting entity should perform a two-step analysis.

6.8.1.1 Step 1 – evaluate the change in cash flows

The first step a reporting entity should perform is the 10% test discussed in FG 3.4. The 10% test should not include any changes in fair value of the embedded conversion option.

If there is an extinguishment under Step 1, there is no need to conduct the additional tests in Step 2. However, if Step 1 does not indicate an extinguishment, the reporting entity should proceed to the tests in Step 2 to determine if extinguishment accounting is required.

6.8.1.2 Step 2 – evaluate the change in the conversion option

If the change in the fair value of the embedded conversion option is greater than 10% of the carrying amount of the original debt instrument immediately before the modification, the modification should be accounted for as an extinguishment. The fair value of the embedded conversion option is generally calculated using an option pricing model, such as the Black-Scholes-Merton model, based on the terms of the embedded conversion option and inputs such as market interest rates, the reporting entity’s stock price, the volatility of the reporting entity’s stock price, and the expected dividend yield on the reporting entity’s stock.

If the modification adds or removes a substantive conversion option from the original debt instrument, the modification should be accounted for as an extinguishment.

See FG 3.7 for information on debt extinguishment accounting. See FG 6.6.5 for information on derecognition of convertible debt with a cash conversion feature. If a modification or exchange requires the application of extinguishment accounting and the new instrument does not require or permit cash settlement upon conversion, the new instrument is no longer subject to the cash conversion guidance in ASC 470-20.
6.8.2 Convertible debt modification accounting

When 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, unseparated conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) should reduce the carrying amount of the convertible debt instrument (increasing debt discount or reducing debt premium) with a corresponding increase in additional paid-in capital. This additional discount should be amortized over the remaining term of the convertible debt. However, a decrease in the fair value of an embedded conversion option resulting from a modification should not be recognized.

The reporting entity should reassess the convertible debt to determine whether (1) the embedded conversion option should be separated and accounted for as a derivative under the guidance in ASC 815 or (2) it is within the scope of the cash conversion guidance in ASC 470-20. A reporting entity should not recognize a BCF or reassess an existing BCF upon a modification or exchange that is accounted for as a modification.

6.8.2.1 Modification of convertible debt with cash conversion feature

When a convertible debt with a cash conversion feature is modified in a transaction that is not accounted for as an extinguishment, a new effective interest rate should be determined to amortize the remaining debt discount. If the modification affects the embedded conversion option so that it no longer requires or permits cash settlement, the liability and equity components should continue to be accounted for separately.

In addition, the reporting entity should reassess the convertible debt to determine whether the embedded conversion option should be separated and accounted for as a derivative under the guidance in ASC 815. See FG 5.4.5 for further information.

6.9 Conversion accounting

If a convertible debt instrument is converted into a reporting entity’s common or preferred stock pursuant to a conversion option in the instrument, it is not an extinguishment; the convertible debt is settled in exchange for equity and no gain or loss is recognized upon conversion. Conversely, the exchange of common or preferred stock for debt that does not contain a conversion right in its original terms is an extinguishment. Such an exchange may also be considered a troubled debt restructuring. See FG 3.3 for information on troubled debt restructurings.

ASC 470-20-40-4 provides guidance on accounting for conversions consistent with the original terms of a convertible debt instrument accounted for as a liability in its entirety.

**ASC 470-20-40-4**

If a convertible debt instrument does not include a beneficial conversion feature, the carrying amount of the debt, including any unamortized premium or discount, shall be credited to the capital accounts upon conversion to reflect the stock issued and no gain or loss is recognized.

We believe debt issuance costs should be treated similar to debt discount or premium; therefore, we believe the carrying amount should include unamortized debt issuance costs. Cash interest expense
should be accrued (or imputed, in the case of a zero coupon convertible debt instrument) up to the date of conversion. If the accrued interest is not paid in cash upon conversion, then it should also be included in the carrying amount of the debt upon conversion. Interest is accrued at the pre-tax amount.

Conversion accounting is only appropriate when the conversion option has not been separated from the debt and accounted for as a derivative based on the guidance in ASC 815 or separately accounted for under the guidance in the cash conversion subsections of ASC 470-20.

Example 6-4 illustrates conversion accounting when convertible debt is accounted for entirely as a liability.

EXAMPLE 6-4
Conversion accounting when convertible debt is accounted for entirely as a liability

FG Corp issues convertible debt that will be settled upon conversion entirely in shares, and concludes that the convertible debt should be accounted for as liability in its entirety.

Debt issuance costs are $10 and are recorded as deferred charges on the balance sheet.

FG Corp’s stock price is $85 at the date the convertible debt is issued. FG’s common stock has a par value of $1 per share. The debt is issued at par.

The convertible debt has the following terms:

<table>
<thead>
<tr>
<th>Principal amount</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coupon rate</td>
<td>5% paid semi-annually on June 30 and December 31</td>
</tr>
<tr>
<td>Years to maturity</td>
<td>5 years</td>
</tr>
<tr>
<td>Conversion price</td>
<td>$100</td>
</tr>
</tbody>
</table>

Two years after FG Corp issues the debt, investors exercise their conversion options. FG Corp’s stock price is $110 at the conversion date. FG Corp has amortized $4 of debt issuance costs by the conversion date; therefore, there are $6 of unamortized debt issuance costs.

How should FG Corp record the conversion of its convertible debt?

Analysis

To derecognize the convertible debt and unamortized debt issuance costs, and recognize the common stock issued upon conversion, FG Corp should record the following entry.
Dr. Convertible debt $1,000
Cr. Deferred debt issuance costs $6
Cr. Common stock – par value $10
Cr. Additional paid-in capital (common stock) $984

As discussed in ASC 470-20-40, the conversion of a debt instrument that becomes convertible upon the reporting entity’s exercise of a call option should be accounted for using the conversion accounting model if, at issuance, the debt instrument contains a substantive conversion feature.

6.9.1.1 Conversion of a convertible debt instrument with a nonsubstantive conversion option

ASC 470-20-40-5(b) provides guidance on the conversion of a debt instrument that becomes convertible upon the reporting entity’s exercise of a call option when the conversion option is nonsubstantive.

**ASC 470-20-40-5(b)**

No substantive conversion feature. If the debt instrument did not contain a substantive conversion feature as of its issuance date (as defined in paragraphs 470-20-30-9 through 30-12), 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.

To be considered substantive, a conversion option should be at least reasonably possible of being exercised in the future. Most conversion options meet that definition and are substantive. However, a conversion option which (1) is exercisable only upon exercise of the reporting entity’s call option, or (2) has an extremely high conversion price relative to the price of the underlying shares at inception may not be substantive.

ASC 470-20-40-7 through ASC 470-20-40-9 provide guidance on determining whether a conversion option is substantive.

6.9.1.2 Induced conversion

An induced conversion is a transaction in which a reporting entity offers additional shares or other consideration (“sweeteners”) to investors to incentivize them to convert their convertible instrument. For example, a reporting entity may reduce the original conversion price or issue additional consideration (e.g., cash or warrants) not provided for in the original conversion terms to debt holders that agree to convert during a limited offer period. ASC 470-20-40-13 and ASC 470-20-40-14 provide guidance on which transactions are induced conversions.
ASC 470-20-40-13

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.

ASC 470-20-40-14

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.

ASC 470-20-40-16 requires a reporting entity to recognize an expense equal to the fair value of the shares or other consideration issued to induce conversion (i.e., the fair value of all consideration transferred in excess of the fair value of the securities transferred pursuant to the original conversion terms).

Question 6-7 discusses what is considered a “limited period of time” as used in ASC 470-20-40-13.

**Question 6-7**

What is a “limited period of time” as used in ASC 470-20-40-13?

**PwC response**

We believe that when evaluating the effective time period of a change in conversion privileges, the reporting entity’s intent in offering the sweetener should be to induce prompt conversion of the convertible instrument. When this assessment is made, the inducement period should be considered in relation to the period in which the instrument is convertible without the sweetener.

Question 6-8 discusses whether an investor’s offer to surrender a convertible instrument in exchange for more shares of stock than it is entitled to under the original conversion terms should be accounted for as an induced conversion or extinguishment.
**Question 6-8**

If an investor offers to surrender a convertible instrument in exchange for more shares of stock than it is entitled to under the original conversion terms and the offer is valid for a limited period of time, should the reporting entity account for the transaction as an induced conversion or extinguishment?

**PwC response**

The reporting entity should account for the transaction as an induced conversion. The party that makes the offer should not affect the accounting; thus, inducement accounting is not affected by which party makes the offer.

Question 6-9 discusses whether an offer to allow investors to tender their convertible instruments in exchange for cash and shares with a total value greater than the value of the shares the investor is entitled to under the original conversion terms should be accounted for as an induced conversion or as an extinguishment.

**Question 6-9**

A reporting entity extends an offer to investors, for a limited period of time, to allow investors to tender their convertible instruments in exchange for cash and shares. The total value of consideration that could be received is greater than the value of the shares that the investor is entitled to under the original conversion terms; however, the number of shares the investor will receive is less than the number of shares it is entitled to under the original conversion terms.

Should the reporting entity account for the transaction as an induced conversion or as an extinguishment?

**PwC response**

The reporting entity should account for the transaction as an extinguishment. ASC 470-20-40-13(b) requires all equity securities issuable pursuant to the original conversion privileges to be issued for the conversion to be an induced conversion. If fewer shares are issued, this condition is not met and extinguishment accounting should be applied.

*Induced conversion—convertible debt with a cash conversion feature*

ASC 470-20-40-26 provides induced conversion guidance for convertible debt with a cash conversion feature that differs from the induced conversion guidance for other convertible instruments.

**ASC 470-20-40-26**

An entity may amend the terms of an instrument within the scope of the Cash Conversion Subsections to induce early conversion, for example, by offering a more favorable conversion ratio or paying other additional consideration in the event of conversion before a specified date. In those circumstances, the entity shall recognize a loss equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of consideration issuable in accordance with the original conversion terms. The settlement accounting (derecognition) treatment described in paragraph 470-20-40-20 is then applied using the fair value of the consideration that was issuable in accordance with the original conversion terms. **The guidance in this paragraph does not apply to derecognition transactions in which the holder does not exercise the embedded conversion option [emphasis added].**
The requirement for an investor to exercise its conversion option for a transaction to be an induced conversion conflicts with the induced conversion guidance otherwise applicable to all convertible instruments in ASC 470-20-40-14, which does not require the conversion option to be exercised.

**ASC 470-20-40-14**

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 [emphasis added]**. 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.

Given this conflict in the accounting literature, we believe a reporting entity should consider its specific facts and circumstances to determine whether the substance of its derecognition transaction involving convertible debt with a cash conversion feature is an induced conversion or an extinguishment. However, we believe the following transactions that are related to a limited time offer and involve additional consideration should be accounted for as induced conversions.

- Transactions in which the investor legally exercises its conversion option early (ASC 470-20-40-26)

- Transactions in which the investor does not exercise its conversion option, but the number of shares delivered is equal to or greater than the notional number of shares underlying the conversion option (i.e., bond principal divided by the conversion price) (ASC 470-20-40-13, ASC 470-20-40-14 and ASC 470-20-40-15)

As discussed in ASC 470-20-40-26, when a reporting entity induces conversion of convertible debt with a cash conversion feature, it should:

- Recognize an inducement charge equal to the difference between (1) the fair value of the consideration delivered to the investor and (2) the fair value of the consideration issuable under the original conversion terms

- Allocate the fair value of the consideration issuable under the original conversion terms to the debt and equity components using the derecognition guidance described in FG 6.6.5

### 6.10 Other rights and arrangements

A convertible instrument may have embedded components other than the embedded conversion option. In addition, a reporting entity may execute agreements in connection with the issuance of a convertible instrument. In the following sections we describe some of the more common embedded components and agreements.

See FG 1.7.1 for information on registration rights and FG 1.6.1 for information on the evaluation of embedded put and call options in debt host instruments.
6.10.1 Contingent interest

A contingent interest feature requires additional interest to be paid only when certain conditions exist. Typically, contingent interest features are included for tax purposes to allow the reporting entity to deduct interest expense in excess of the cash coupon paid, although the extra deductions are subject to recapture. In addition, contingent interest can deter investors from exercising their put or conversion option. Prior to conversion (or extinguishment) the reporting entity should continue to deduct interest expense in excess of the cash coupon paid.

A contingent interest provision in convertible debt typically requires the payment of additional interest if the instrument’s average trading price is at a specified level above or below par value. For example, a provision may call for contingent interest in the amount of 25 basis points multiplied by the instrument’s trading price to be paid if the average trading price is above $120. Many contingent interest features become effective only after a simultaneous put and call date.

A contingent interest feature that meets the definition of a derivative should be considered clearly and closely related to a debt host when indexed solely to interest rates and credit risk. However, the trading price of a convertible debt instrument is a function of more than just interest rates and credit risk due to the embedded conversion option. As a result, contingent interest features in convertible debt instruments that are indexed to the instrument’s trading price are generally not considered clearly and closely related to the debt host and should be separated and accounted for as a derivative. Many contingent interest features are not material to a reporting entity’s financial statements initially; however, a reporting entity should monitor the value of a contingent interest feature and periodically assess its materiality even if initially immaterial, as the value may change over time.

The determination of the likelihood of paying contingent interest should be consistent for book and tax purposes. That is, if a reporting entity determines that the value of the contingent interest feature is not material because the likelihood of payment is remote, then the same assertion should be used when determining if the interest is deductible for tax purposes. See TX 9.4.2 for information on the tax accounting considerations of contingent interest.

6.10.2 Greenshoe (overallotment option)

A greenshoe is a freestanding agreement between a reporting entity and an underwriter that allows the underwriter to call additional securities to “upsize” the amount of securities issued. For example, a 15% greenshoe on a $100 million convertible debt offering may allow an underwriter to require the reporting entity to issue an additional $15 million of debt at par value. The term “greenshoe” comes from the name of the company (Green Shoe Manufacturing) that first used such an agreement with its underwriter.

Prior to the issuance of a convertible instrument, an underwriter will take orders from investors. The underwriter will then allocate the base amount plus any greenshoe amount to the investors. The amount allocated to investors in excess of the base amount is called an overallotment. The underwriter can fill an overallotment by exercising the greenshoe.

There are several types of greenshoes, the most common being an overallotment option. An overallotment option allows the underwriter to call additional securities from the reporting entity only to fill overallotments. The underwriter cannot exercise an overallotment option and hold or sell the securities for its own account. Other types of greenshoes allow the underwriter full discretion over the securities received by exercising their option.
A greenshoe on a publicly traded instrument generally will meet the definition of a derivative and, for issuances of convertible debt, will not meet the requirements for the scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a). As a result, a greenshoe on publicly traded debt is generally accounted for as a derivative under the guidance in ASC 815. Greenshoes are generally short-dated and, as such, may not have a value material to the reporting entity’s financial statements.

A greenshoe on a privately placed instrument may not meet the definition of a derivative if the instrument is not readily convertible to cash. In that case, the greenshoe on privately placed debt should not be separately accounted for as a derivative. Rather, there should be no accounting until any additional debt instruments are issued under the greenshoe.

See Question 7-6 for information on the effect a greenshoe may have on the measurement of a beneficial conversion feature.

### 6.10.3 Call option overlay

A call option overlay (call spread, capped call) is a transaction executed between a reporting entity issuing a convertible debt instrument and an investment bank. In a call option overlay, the reporting entity buys a call option from the investment bank that mirrors the conversion option embedded in the convertible debt instrument, effectively “hedging” or canceling the economic effect of the embedded conversion option. The reporting entity pays a premium to the investment bank to buy this option. The reporting entity then sells a call option to the investment bank, almost always at a higher strike price than the embedded conversion option and purchased call option, effectively raising the strike price of the convertible debt instrument transaction. If the strike price of the sold call option is higher than the strike price of the purchased call option, the reporting entity will receive a lower premium from the investment bank for selling this option.

The primary reasons a reporting entity may execute a call option overlay transaction are (1) to receive additional tax benefits and (2) to synthetically raise the strike price on the convertible debt instrument.

A call option overlay may be executed as two separate call option transactions—referred to as a call spread—or it can be executed as a single integrated transaction—referred to as a capped call. A call spread and a capped call are accounted for separately from the convertible debt instrument with which they are issued or associated. A call spread is accounted for as two transactions (1) a purchased call option on the reporting entity’s own stock and (2) a written call option on the reporting entity’s own stock at a higher strike price, whereas a capped call is accounted for as a single transaction. See FG 5.6 for information on the analysis of freestanding equity-linked instruments.

A call option overlay is included in diluted EPS based on the form of the transaction. A capped call generally is not included in diluted EPS because it is anti-dilutive. In a call spread, however, the purchased call is not included in diluted EPS because it is anti-dilutive, but the sold call is included in diluted EPS when dilutive. This can create so called “double dilution” from the convertible debt instrument and the sold call, if the reporting entity’s stock price increases to a level above the strike price on the sold call.
6.10.4 **Share-lending arrangements**

Less commonly, a reporting entity issuing a convertible debt instrument may enter into a share-lending agreement with an investment bank. A share-lending agreement is intended to facilitate the ability of investors, primarily hedge funds, to borrow shares to hedge the conversion option in the convertible debt instrument. Typically, they are executed in situations where the issuing reporting entity’s stock is difficult or expensive to borrow in the conventional stock borrow market.

The terms of a share-lending arrangement typically require the reporting entity to issue (loan) shares to the investment bank in exchange for a small fee, generally equal to the par value of the common stock. Upon conversion or maturity of the convertible debt, the investment bank is required to return the loaned shares to the reporting entity. The shares issued are legally outstanding, entitled to vote, and entitled to dividends, although under the terms of the arrangement the investment bank may agree to reimburse the issuer for dividends received and may agree not to vote on any matters submitted to a vote of the reporting entity’s shareholders.

ASC 470-20-25-20A and ASC 470-20-35-11A provide guidance on the accounting for a share-lending arrangement.

**ASC 470-20-25-20A**

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.

**ASC 470-20-35-11A**

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.

Amortization of the discount created by the debt issuance cost will increase the overall implied cost of the convertible debt. See FG 1.2.3 for information on the amortization of debt issuance costs.

See FSP 7.4.3.7 for information on the earnings per share treatment of share lending arrangements.
Chapter 7: Preferred stock
7.1 Chapter overview

This chapter discusses the accounting for preferred stock, including convertible preferred stock. It addresses classification and measurement, the accounting for preferred stock issuance costs, participation rights, and dividends; it also discusses the accounting for modifications and extinguishments of preferred stock.

For information on common stock, see FG 4. For information on convertible debt, see FG 6.

7.2 Characteristics of preferred stock

Preferred stock (also called preferred shares or preference shares) is a class of ownership in a reporting entity that is senior to common stock and subordinate to debt. The terms of preferred stock can vary significantly. A reporting entity may issue several series of preferred stock with different features and priorities on dividends or assets in case of liquidation. Preferred stock may have characteristics of equity, debt, or both. Figure 7-1 summarizes some of the common characteristics of preferred stock.

Figure 7-1
Characteristics of preferred stock

<table>
<thead>
<tr>
<th>Feature</th>
<th>Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidation preference</td>
<td>Preferred shareholders have a claim on a reporting entity’s assets senior to common shareholders and subordinate to bondholders and other creditors</td>
</tr>
<tr>
<td>Dividends</td>
<td>Generally, preferred shareholders receive dividends before common shareholders; the dividend is typically fixed and may be cumulative or non-cumulative</td>
</tr>
<tr>
<td></td>
<td>Preferred shareholders may be entitled to receive additional dividends when dividends are paid to common shareholders (participating preferred stock)</td>
</tr>
<tr>
<td>Voting</td>
<td>Preferred stock may be voting or nonvoting; some preferred stock may have voting rights for certain extraordinary events (e.g., a takeover of the reporting entity, the issuance of new shares)</td>
</tr>
<tr>
<td>Term</td>
<td>Preferred stock may be perpetual, mandatorily redeemable on a specified date, or contingently redeemable either upon election of the holder, occurrence of an event, or at a point in time</td>
</tr>
<tr>
<td>Conversion option</td>
<td>Convertible preferred stock either requires or permits the investor to convert the instrument into equity securities of the issuer. Some convertible preferred shares are convertible only upon the occurrence of a specified contingent event (e.g., upon an IPO).</td>
</tr>
<tr>
<td>Put option exercisable by the preferred shareholder</td>
<td>Preferred stock may be puttable at the option of the shareholder after a certain period (e.g., 5 years), or upon the occurrence of an event (e.g., a change in control)</td>
</tr>
</tbody>
</table>
7.1 Redeemable Features

There are two types of preferred stock redemption features, mandatory redemption and contingent redemption. Perpetual preferred stock is preferred stock that does not provide for redemption. The typical accounting classification for each of these types of preferred stock is summarized in Figure 7-2. When a preferred share is redeemable (or contingently redeemable) at the option of the issuer, permanent equity classification assumes the preferred shareholder does not control the board of directors (or could control the board as a result of events outside the reporting entity’s control, such as a debt default). In that case, the preferred shareholders are able to force the reporting entity to redeem their shares for cash.

Figure 7-2
Preferred stock redemption features

<table>
<thead>
<tr>
<th>Type</th>
<th>Liability or equity</th>
<th>Mezzanine or permanent equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mandatorily redeemable without a substantive conversion option</td>
<td>Liability</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Mandatorily redeemable with a substantive conversion option</td>
<td>Equity</td>
<td>Mezzanine equity</td>
</tr>
<tr>
<td>Redeemable (puttable) at the shareholder’s option</td>
<td>Equity</td>
<td>Mezzanine equity</td>
</tr>
<tr>
<td>Contingently redeemable (puttable) at the shareholder’s option</td>
<td>Equity</td>
<td>Mezzanine equity</td>
</tr>
<tr>
<td>Redeemable (callable) at the issuer’s option</td>
<td>Equity</td>
<td>Permanent equity</td>
</tr>
<tr>
<td>Contingently redeemable (callable) at the issuer’s option</td>
<td>Equity</td>
<td>Permanent equity</td>
</tr>
<tr>
<td>No redemption (perpetual preferred stock)</td>
<td>Equity</td>
<td>Permanent equity</td>
</tr>
</tbody>
</table>

7.3 Classification of preferred stock

Figure 7-3 provides a flowchart outlining the analysis to determine the classification and accounting treatment of preferred stock. Put and call options embedded in preferred stock should also be evaluated to determine whether they should be accounted for separately as a derivative. See FG 7.3.3
Figure 7-3
Classification and accounting treatment of preferred stock

ASC 480, *Distinguishing Liabilities from Equity*, defines “mandatorily redeemable” financial instruments, which may include some preferred shares. At the same time, the SEC prescribes specific accounting for “preferred stock subject to mandatory redemption,” which is codified in ASC 480-10-S99. While the two terms are similar, they are not synonymous and the respective accounting treatments differ. If a preferred share meets the definition of a mandatorily redeemable financial instrument in ASC 480-10-20, the SEC guidance in ASC 480-10-S99 is not applicable.
**7.3.1 Determine whether the preferred stock is a liability based on the guidance in ASC 480**

The first step to determine the appropriate accounting classification for preferred stock is to evaluate the instrument’s provisions to determine whether the share should be classified as a liability because it is a mandatorily redeemable financial instrument or is required to be classified as a liability based on another provision in ASC 480.

To determine whether preferred stock is a mandatorily redeemable financial instrument, all provisions that could result in the redemption of the preferred stock should be assessed. This includes provisions labeled as a redemption feature, call option or conversion option. For example, a conversion option that requires the issuer to deliver cash or a variable number of shares with a value equal to the redemption amount of a preferred share is, in substance, a redemption feature. See FG 7.3.1.2 for additional information.

**7.3.1.1 Mandatorily redeemable financial instrument**

ASC 480-10-20 provides a definition of a mandatorily redeemable financial instrument, which is classified as a liability based on the guidance in ASC 480-10-25-4.

**Definition from ASC 480-10-20**

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.

Provisions that defer, delay, or accelerate the timing of redemption do not affect the classification of a mandatorily redeemable financial instrument as a liability, as long as the unconditional requirement to redeem the instrument remains.

Common examples of mandatorily redeemable preferred stock include the following:

- Preferred stock (nonconvertible, or convertible, if conversion option is not substantive) that must be redeemed on a specified date
- Preferred stock that must be redeemed in the event of the employee’s death or termination of employment
- Preferred stock that is redeemable subject to a liquidity provision (such as a requirement to maintain adequate liquidity). A liquidity provision may affect the timing of the unconditional requirement for redemption but does not eliminate the redemption requirement.

The definition of mandatorily redeemable specifically excludes instruments that are redeemable only upon the liquidation or termination of a reporting entity.
**Preferred stock**

**ASC 480-10-25-4**

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.

Question 7-1 discusses whether preferred stock redeemable upon liquidation of a partnership or upon the death or termination of a partner are considered mandatorily redeemable.

**Question 7-1**

A partnership has a life of 25 years. It issues two series of preferred stock. Series A is redeemable upon liquidation of the partnership. Series B is redeemable upon the death or termination of the partner holding the shares.

Are the Series A and Series B shares mandatorily redeemable financial instruments?

**PwC response**

The Series A shares are not mandatorily redeemable financial instruments because the guidance in ASC 480-10-25-4 specifically excludes instruments redeemable only upon the liquidation or termination of the reporting entity.

The Series B shares are also not mandatorily redeemable because the redemption event (death or termination of the partner) is not certain to occur within the life of the partnership (25 years). If, however, the life of the partnership is 100 years, and the partner is 50 years old, the partner’s equity interest would be considered mandatorily redeemable as it is based on an event (death or termination of the partner within 100 years) that is certain to occur. Certain mandatorily redeemable financial instruments issued by nonpublic entities are not within the scope of ASC 480. See FG 5.51.4 for information.

**Contingently redeemable preferred stock**

Contingently redeemable preferred stock is redeemable only upon the satisfaction of a specified contingency. For example, the following instruments are contingently redeemable.

- Preferred stock that is automatically redeemed if there is a change in control or successful initial public offering

- Preferred stock that the shareholder has the option to redeem (e.g., preferred stock with a put option or puttable stock). In this case, the shareholder may or may not exercise its option

As discussed in ASC 480-10-25-7, contingently redeemable preferred stock with a substantive condition for redemption is not considered a mandatorily redeemable financial instrument until the contingency is met.
Contingently redeemable preferred stock that is redeemable upon the occurrence of a nonsubstantive contingency is considered mandatorily redeemable. A conversion price that is so high relative to the current share price that the likelihood of the stock price ever reaching the conversion price is remote, is an example of a nonsubstantive condition. The determination of whether a conditional redemption feature is substantive should generally be performed only upon issuance and should not be reevaluated. A reporting entity should consider reevaluation when an instrument is modified so significantly that it is considered an extinguishment of the original instrument and the issuance of a new instrument. See FG 5.5 for further information on the application of ASC 480.

In addition, preferred shares that contain a redemption provision that only affects the timing of the redemption (but does not remove the redemption requirement), such as an adequate liquidity clause or term-extending option, are also mandatorily redeemable. These preferred shares should be classified as a liability under the guidance in ASC 480.

A contingently redeemable financial instrument should be reclassified as a liability when the contingent event has occurred or becomes certain to occur, making the instrument unconditionally redeemable. The reclassification should be recorded by debiting equity and crediting a liability equal to the fair value of the preferred stock. The difference between the fair value and the carrying amount of the preferred stock should be subtracted from (or added to) net income available to common shareholders when computing basic and diluted EPS as discussed in ASC 260-10-S99.

Question 7-2 addresses whether a reporting entity is required to periodically reassess if preferred shares that are callable and mandatorily redeemable are considered contingently redeemable or mandatorily redeemable.

**PwC response**

Yes. ASC 480 requires a reporting entity to assess whether an instrument is mandatorily redeemable at each reporting period. The Series C preferred shares should be initially classified as equity because redemption is conditional upon the occurrence of an event that is not certain to occur. However, upon a change in control, the Series C shares should be reclassified as a liability.
Question 7-3 discusses how an issuer should classify preferred stock when it calls the stock for redemption subsequent to the period-end date, but prior to the financial statement issuance date.

**Question 7-3**

If an issuer calls its preferred stock on 12/15/X1 for redemption on 1/15/X2, should it classify the shares as mandatorily redeemable in its 12/31/X1 financial statements?

**PwC response**

Yes. If the call is irrevocable, the shares should be reclassified as a liability until the shares are redeemed.

**Convertible preferred stock with mandatory redemption date**

Convertible preferred stock with a substantive conversion option and a date-certain redemption date is not mandatorily redeemable because the redemption event is not certain to occur; the conversion option could be exercised prior to the redemption date. Preferred stock that contains a conversion feature that is so high relative to the current share price that the likelihood of the stock price ever reaching the conversion price is remote is an example of an instrument with a nonsubstantive conversion option. See FG 5.5.1.3 for information on nonsubstantive or minimal features.

**Preferred stock that must be settled in a variable number of shares**

Convertible preferred stock may contain settlement provisions that cause it to be a liability within other scope provisions of ASC 480. For example, a convertible preferred share that requires the delivery of a variable number of shares upon conversion could be within the scope of ASC 480-10-25-14. That guidance requires instruments that will result in the delivery of a variable number of shares that have a value solely or predominantly based on a fixed monetary amount to be accounted for as a liability.

Question 7-4 addresses whether convertible preferred stock that automatically converts into a fixed number of common shares on a specified date is a liability within the scope of ASC 480.

**Question 7-4**

Is convertible preferred stock that automatically converts into a fixed number of common shares on a specified date a liability within the scope of ASC 480?

**PwC response**

No. This instrument is outside the scope of ASC 480. ASC 480-10-25-14 potentially applies only if the number of shares is variable.

Question 7-5 addresses whether convertible stock that automatically converts into the number of common shares equivalent to the stated value of the preferred stock is considered a liability within the scope of ASC 480.
**Question 7-5**

Is convertible preferred stock that automatically converts into the number of common shares equivalent to the $1,000,000 stated value of the preferred stock a liability within the scope of ASC 480?

**PwC response**

Yes. The preferred stock converts into a variable number of shares and the monetary value of the obligation is based solely on a fixed monetary amount (stated value) known at inception. Accordingly, it should be classified as a liability under the guidance in ASC 480-10-25-14.

In addition, preferred stock that allows the issuer to choose to redeem the stock in cash or in a variable number of shares that have a fair value equal to the redemption amount on the redemption date should be classified as a liability under ASC 480.

Question 7-6 discusses if preferred stock that converts to a variable number of shares based upon the then-current market price of the common stock should be recorded as a liability within the scope of ASC 480.

**Question 7-6**

A reporting entity issues convertible preferred stock that automatically converts into a variable number of shares based on the then-current market price of the common stock. If the market price of the common stock is (1) less than $50, the reporting entity will issue 1 share, (2) between $50 and $62.50, the reporting entity will issue a pro rata portion of shares between 1 share and 0.8 share equaling $50, (3) greater than $62.50, the reporting entity will issue 0.8 shares. Should the preferred stock be recorded as a liability within the scope of ASC 480?

**PwC response:**

It depends. The reporting entity should assess whether the settlement alternative that results in the issuance of a variable number of shares with a fixed monetary value (i.e., when the stock price is between $50 and $62.50) is the predominant settlement alternative at issuance of the convertible preferred stock. The determination of predominance depends on the facts and circumstances of each transaction. See FG 5.5.1.1 for further information.

If the reporting entity determines that the monetary value of the obligation to issue common shares is based predominantly on a fixed monetary amount known at issuance, the preferred stock should be classified as a liability under the guidance in ASC 480-10-25-14.

**7.3.1.3 Preferred stock exchangeable into debt**

Some preferred stock contains a provision that requires a mandatory exchange into debt on a specified date. This feature allows a reporting entity to “swap” after-tax dividends for tax deductible interest payments. This type of preferred stock is a liability within the scope of ASC 480.

Preferred stock with a mandatory exchange-into-debt feature that is convertible into common shares at the option of the shareholder is outside the scope of ASC 480 because the shareholder could convert the preferred stock into common stock prior to the mandatory exchange date. These shares should be
7.3.2 Evaluate conversion options

The following sections provide information for navigating the appropriate accounting by the issuer of convertible preferred stock. See Figure 7-3 for an illustration of these steps.

ASC 815, *Derivatives and Hedging*, provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative.

**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 this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

An embedded equity-linked component is generally considered clearly and closely related to an equity host; it is not considered clearly and closely related to a debt host. A host contract is the instrument or contract that would be issued if a hybrid instrument did not contain an embedded component; it’s the hybrid instrument without the embedded component.

**Determining the nature of the host contract for a convertible preferred share**

To determine its nature, the reporting entity needs to consider the host contract’s underlying economic characteristics and risks. Whether a host instrument is an equity or debt host is not determined by its balance sheet classification. An instrument may be classified as equity, but considered a debt host contract for purposes of evaluating embedded components.

Determining whether a hybrid instrument that is legally an equity instrument (e.g., a preferred share) is a debt or equity host contract requires judgment. As discussed in ASC 815-15-25-17A, all of the contractual and implied terms of the preferred share, such as the existence of a redemption feature or conversion option, should be considered when determining the nature of the host instrument as debt or equity.
**ASC 815-15-25-17A**

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.

**Excerpt from ASC 815-15-25-17C**

When applying the guidance in paragraph 815-15-25-17A, ...an entity shall consider not only whether the relevant terms and features are debt-like versus equity-like, but also the substance of those terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances). In assessing the substance of the relevant terms and features, each of the following may form part of the overall analysis and may inform an entity’s overall consideration of the relative importance (and, therefore, weight) of each term and feature among other terms and features:

a. The characteristics of the relevant terms and features themselves (for example, contingent versus noncontingent, in-the-money versus out-of-the-money)

b. The circumstances under which the hybrid financial instrument was issued or acquired (for example, issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized)

c. The potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes. The assessment of the potential outcomes may be qualitative in nature.

Figure 7-4 shows some common attributes that should be analyzed to determine the nature of the host contract. None of these factors alone is determinative of the nature of a host contract; the terms and conditions as a whole should be evaluated. ASC 815-15-25-17D provides additional guidance on assessing each of these attributes.
## Figure 7-4
Analyzing the nature of the host contract

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Indicates the instrument is debt-like</th>
<th>Indicates the instrument is equity-like</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redemption provision</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Conversion option</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Cumulative or mandatory fixed dividends</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Discretionary dividends based on earnings</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Voting rights</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Collateral requirement</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Participation in the residual equity of the issuer</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Preference in liquidation</td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

Question 7-7 asks whether a preferred share that is considered a debt host for purposes of the evaluation of embedded components should be classified as debt by the issuer.

### Question 7-7
If a preferred share is considered a debt host for purposes of the evaluation of embedded components, should it be classified as debt by the issuer?

**PwC response**

No. Whether the host contract is a debt host or an equity host does not determine the instrument’s balance sheet classification. A preferred share that is considered a debt host for purposes of evaluating embedded components should not necessarily be classified as debt by the issuer.

**Determining whether an embedded conversion option meets the definition of a derivative**

When preferred stock is determined to be a debt host instrument, the next step is to determine whether a conversion option meets the definition of a derivative. To do this, its terms should be evaluated under the guidance in ASC 815-10-15-83. Often, the criterion that determines whether a conversion option meets the definition of a derivative is the net settlement criterion. Some convertible preferred shares contain a provision allowing the holder to surrender the convertible preferred shares in exchange for cash equal to the conversion value. This type of provision allows net cash settlement of the conversion option, which would cause the conversion option to meet the definition of a derivative.
In addition, if the equity securities underlying the embedded conversion option are readily convertible to cash, such as publicly traded common shares, the embedded conversion option is also likely to meet the net settlement criterion to be considered a derivative. If the equity securities underlying the conversion option are not readily convertible to cash, the embedded conversion option may not meet the net settlement criterion, and therefore would not meet the definition of a derivative. See FG 5.4.2 for further information on the concept of readily convertible to cash and DH 2 for further information on other forms of net settlement.

If an embedded conversion option meets the definition of a derivative, a reporting entity should assess whether it qualifies for the scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

**Determining whether an embedded conversion option is eligible for the scope exception for contracts involving a reporting entity’s own equity**

ASC 815-10-15-74(a) provides a scope exception to the derivative accounting required under ASC 815 for certain contracts involving a reporting entity’s own equity.

**ASC 815-10-15-74(a)**

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
   2. Classified in stockholders’ equity in its statement of financial position.

An embedded component is considered indexed to a reporting entity’s own stock if it meets the requirements specified in ASC 815-40-15. See FG 5.6.2 for information on those requirements.

**7.3.2.1 Accounting for convertible instrument with a separated conversion option**

When a reporting entity concludes that a conversion option should be separated from its host instrument and accounted for as a derivative, it should be accounted for as a freestanding derivative instrument under the guidance in ASC 815. That is, it should be classified on the balance sheet as a derivative liability at fair value with any changes in its fair value recognized currently in the income statement. The preferred shares should be accounted for using the guidance applicable to similar nonconvertible preferred shares.

ASC 815-15-30-2 through ASC 815-15-30-6 provide guidance on allocating the carrying amount of a hybrid instrument between the host contract and the derivative. That guidance requires the derivative to be recorded at fair value, with the host contract carried at a value equal to the difference between the previous carrying amount of the hybrid instrument and the fair value of the derivative. Therefore, there is no gain or loss from the initial recognition and measurement of an embedded derivative that is accounted for separate from its host contract.
ASC 815 requires forward-based derivatives to be separated with an initial fair value of zero, while option-based derivatives should be valued based on their stated terms. The embedded derivative in this case is an option (conversion option); therefore, as discussed in ASC 815-15-30-6, a reporting entity should determine the fair value of a separated option based on its stated contract terms. Doing this will result in the conversion option having a value greater than zero (due to the option time value). As a result, the allocation of proceeds to the separated derivative will typically create a discount in the associated host preferred stock.

### 7.3.2.2 Beneficial conversion features

Any convertible instrument may contain a beneficial conversion feature (BCF) or contingent BCF if the conversion option is not accounted for separately. A warrant to acquire a convertible instrument may also contain a BCF. See FG 8.2.2.4 for additional information on warrants to acquire a convertible instrument.

The ASC Master Glossary provides the definition of a beneficial conversion feature.

**Definition from ASC Master Glossary**

Beneficial Conversion Feature: A nondetachable conversion feature that is in the money at the commitment date.

A convertible instrument contains a BCF when the conversion price is less than the fair value of the shares into which the instrument is convertible at the commitment date. See FG 7.9.2 for information on the conversion of convertible preferred stock with a BCF.

**Determining the commitment date**

The commitment date is the date on which an agreement meets the definition of a firm commitment. To have a firm commitment, a reporting entity should have a legally-enforceable agreement that specifies the significant terms and provides a disincentive for nonperformance that is sufficiently large to make performance probable.

ASC 470-20, *Debt with Conversion and Other Options*, provides guidance on determining a convertible instrument’s commitment date.

**ASC 470-20-30-12**

If an agreement includes subjective provisions that permit either party to rescind its commitment to consummate the transaction, a commitment date does not occur until the provisions expire or the convertible instrument is issued, whichever is earlier. Both of the following are examples of subjective provisions that permit either party to rescind its commitment to consummate the transaction:

- A provision that allows an investor to rescind its commitment to purchase a convertible instrument in the event of a material adverse change in the issuer’s operations or financial condition

- A provision that makes the commitment subject to customary due diligence or shareholder approval.
As a practical matter, because of clauses such as those in (a) and (b), the commitment date typically does not occur until the date the convertible instrument is issued (i.e., the date cash and securities are exchanged).

Question 7-8 discusses the commitment date for convertible instruments issued under an overallotment option.

**Question 7-8**

When is the commitment date for convertible instruments issued under an overallotment option (greenshoe)?

**PwC response**

The commitment date for instruments issued under a greenshoe is the date the underwriter exercises its greenshoe and the securities are delivered. Prior to then, there is no commitment on the part of the underwriter to purchase the securities. It is possible for a convertible instrument that was out-of-the-money when it was priced (so that there is no beneficial conversion feature for the initial securities sold) to be in-the-money on the date the greenshoe is exercised. This would result in a BCF for the securities sold under the greenshoe. See FG 6.10.2 for information on greenshoes.

Question 7-9 addresses how a private reporting entity that issues a convertible instrument prior to an IPO should assess whether a BCF exists.

**Question 7-9**

If a private reporting entity issues a convertible instrument prior to an IPO with a conversion price below the IPO price, should the reporting entity assess whether a BCF exists based on the commitment date estimated fair value of the shares or the IPO price?

**PwC response**

A reporting entity should consider all information available when estimating the commitment date fair value of its common stock, including the anticipated IPO price. The SEC staff has said that convertible instruments with a conversion price below the IPO price issued within one year of the filing of an initial registration statement are presumed to contain a BCF.

To overcome this presumption, a reporting entity would have to make an assertion that the accounting conversion price represented fair value at the commitment date (i.e., the issue date) and should ensure that appropriate evidence exists to support that assertion. As part of this process, reporting entities should consider any valuations that an underwriter has discussed with management and/or the board of directors.

**Determining the conversion price**

To determine whether a convertible instrument contains a BCF, a reporting entity should compare the conversion price and the reporting entity’s stock price on the commitment date. The conversion price is calculated by dividing the proceeds allocated to the convertible instrument by the number of shares into which the instrument is convertible. Often, the conversion price is the same as the instrument’s contractual conversion rate; however, in some cases, the conversion price does not equal the stated
Preferred stock

conversion rate. For example, when detachable warrants are issued with a convertible instrument, the reporting entity should allocate the proceeds between the convertible instrument and the warrants. This reduces the proceeds allocated to the convertible instrument and as a result, lowers the conversion price.

Issuance costs do not affect whether an instrument contains a BCF.

**BCFs in instruments issued to pay dividends or interest in kind**

Some convertible instruments require or allow declared dividends or accrued interest to be paid in kind (PIK) with additional units of that convertible instrument, or a different series of convertible instruments. To determine whether a convertible instrument issued to satisfy a required dividend or interest payment contains a BCF, the commitment date for the newly issued convertible instrument must be determined. The commitment date of the newly issued convertible instrument will ultimately depend upon whether payment in kind is discretionary.

ASC 470-20-30-16 and ASC 470-20-30-18 provide guidance on the commitment date for instruments that pay in kind.

**ASC 470-20-30-16**

If dividends or interest on a convertible instrument must be paid in kind with the same convertible instruments as those in the original issuance and are not discretionary, the commitment date for the original instrument is the commitment date for the convertible instruments that are issued to satisfy interest or dividends requirements.

**Excerpt from ASC 470-20-30-18**

Otherwise, the commitment date for the convertible instruments issued as paid-in-kind interest or dividends is the date that the interest or the dividends are accrued and the fair value of the underlying issuer stock at the recognition or declaration date shall be used to measure the intrinsic value of the conversion option embedded in the paid-in-kind instruments.

**Measurement and recognition**

A BCF is measured as the intrinsic value of the conversion option at the commitment date, representing the difference between the conversion price and the reporting entity’s stock price on the commitment date.

A BCF should be separated from a convertible instrument and recorded in additional paid-in capital. SEC registrants should present the BCF as mezzanine equity in periods in which it is redeemable, as described in ASC 480-10-S99-3A.

**Excerpt from ASC 480-10-S99-3A**

...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).
Although technically not required for nonpublic entities, mezzanine equity presentation is strongly encouraged. See FG 7.3.4 for more information on mezzanine presentation.

Separating a BCF will create a discount in the convertible instrument which will result in additional interest expense or dividends.

**Instruments with a multiple-step discount**

Some convertible instruments have a conversion price that decreases over time; this is called a multiple-step discount. ASC 470-20-30-15 provides guidance on determining the intrinsic value of a convertible instrument with a multiple-step discount.

**Excerpt from ASC 470-20-30-15**

If an instrument incorporates a multiple-step discount, the computation of the intrinsic value shall use the conversion terms that are most beneficial to the investor.

For example, assume convertible preferred stock has a conversion price of (1) $10 at issuance, (2) $9 six months after issuance, (3) $8 twelve months after issuance and (4) $7 twenty-four months after issuance. The reporting entity should compare the most favorable conversion price to the investor (in this example, the conversion price of $7, twenty-four months after issuance) and compare that with the commitment date stock price to determine the BCF amount, if any.

**Contingently adjusting conversion prices**

Some convertible instruments have a conversion price that adjusts if certain contingent events occur. As noted in ASC 470-20-30-7, a reporting entity should measure a BCF using the most favorable conversion price that will be in effect at the conversion date presuming there will be no change in circumstances other than the passage of time. That is, it should not include future contingent adjustments in the measurement of the BCF, but would nonetheless need to consider whether a BCF is present without the contingent adjustment.

Example 7-1 and Example 7-2 illustrate how to measure and record a BCF in convertible preferred stock issued with warrants.

**EXAMPLE 7-1**

**BCF measurement and recognition**

FG Corp issues $1,000 par value convertible preferred stock and 100 detachable warrants to purchase its common stock, in exchange for $1,000 in cash. FG’s stock price on the date the instruments are issued, which is the commitment date, is $18 per share.

The convertible preferred stock has a stated conversion price of $20; therefore, it is convertible into 50 shares of FG Corp’s common stock ($1,000 par value / $20 conversion price).

FG Corp concludes that the warrants meet the requirements for equity classification. Since the warrants are classified as equity, FG Corp allocates the proceeds from the issuance of the preferred stock and warrants using the relative fair value method. The sales proceeds allocated to the convertible preferred stock and warrants are $700 and $300, respectively.
How should FG Corp record the issuance of the convertible preferred stock and warrants?

**Analysis**

FG Corp should first determine whether the convertible preferred stock contains a BCF by determining the conversion price and comparing it to FG Corp’s stock price on the commitment date.

The effective conversion price is calculated by dividing (1) the proceeds allocated to the convertible preferred stock by (2) the number of shares into which the debt is convertible.

$700 / 50 shares = $14 conversion price

The convertible preferred stock does contain a BCF because the $18 commitment date stock price is greater than the $14 accounting conversion price.

The BCF is measured as the difference between the commitment date stock price and the conversion price multiplied by the number of shares into which the preferred stock is convertible.

($18 - $14) x 50 = $200

To record the issuance of the convertible debt and warrants, FG Corp should record the following journal entry.

<table>
<thead>
<tr>
<th>Dr.</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>Dr. Discount on convertible preferred stock (warrants)</td>
<td>$300</td>
</tr>
<tr>
<td>Dr. Discount on convertible preferred stock (BCF)</td>
<td>$200</td>
</tr>
<tr>
<td>Cr. Convertible preferred stock</td>
<td>$1,000</td>
</tr>
<tr>
<td>Cr. Additional paid-in capital (warrants)</td>
<td>$300</td>
</tr>
<tr>
<td>Cr. Additional paid-in capital (BCF)</td>
<td>$200</td>
</tr>
</tbody>
</table>

**EXAMPLE 7-2**

**BCF measurement and recognition**

FG Corp issues $1,000 of convertible perpetual preferred stock and 100 detachable warrants to purchase its common stock in exchange for $1,000 cash. The convertible preferred stock is convertible into 100 shares ($1,000 convertible preferred stock / 100 shares = $10 conversion price) immediately upon issuance. The warrants have a strike price of $10 per share.

FG Corp’s stock price on the date the instrument is issued, which is the commitment date, is $10 per share. The fair value of the warrants on that date is $300.

FG Corp concludes that the warrants should be classified as a liability. Since the warrants are classified as a liability, FG Corp first allocates the proceeds to the warrant based on its fair value ($300); the remaining proceeds ($700) are allocated to the convertible preferred stock.
How should FG Corp record the issuance of the convertible preferred stock and warrants?

**Analysis**

FG Corp should first determine whether the convertible preferred stock contains a BCF by determining the accounting conversion price and comparing that to FG Corp’s stock price on the commitment date.

The effective conversion price would be calculated by dividing (1) the proceeds allocated to the convertible preferred stock by (2) the number of shares into which it is convertible.

$700 / 100 shares = $7 conversion price

The convertible preferred stock contains a BCF because the $10 commitment date stock price is greater than the $7 accounting conversion price.

The BCF is measured as the difference between the commitment date stock price and the accounting conversion price multiplied by the number of shares into which the preferred stock is convertible.

($10 - $7) × 100 = $300

To record the issuance of the convertible debt and warrants, FG Corp would record the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>Dr. Discount on convertible preferred stock</td>
<td>$300</td>
</tr>
<tr>
<td>Cr. Warrant liability</td>
<td>$300</td>
</tr>
<tr>
<td>Cr.Convertible preferred stock</td>
<td>$700</td>
</tr>
<tr>
<td>Cr. Additional paid-in capital (BCF)</td>
<td>$300</td>
</tr>
</tbody>
</table>

Because the convertible preferred shares are perpetual (have no stated maturity date) and are convertible at any time, the discount created in the convertible preferred stock is fully amortized at issuance (i.e., recorded as a deemed dividend), thereby increasing the convertible preferred stock’s carrying amount to $700.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Retained earnings</td>
<td>$300</td>
</tr>
<tr>
<td>Cr. Discount on convertible preferred stock</td>
<td>$300</td>
</tr>
</tbody>
</table>

**Contingent BCFs**

A reporting entity may issue convertible debt with a conversion price that adjusts over the term of the instrument. For example, the conversion price may be reduced if the fair value of the underlying stock declines to, or below, a specified price after the commitment date.

In such situations, a reporting entity must determine not only whether a BCF is present at inception, but must also measure and account for the contingently adjustable conversion ratio, which is
Preferred stock

Referring to ASC 470-20-35-1 through ASC 470-20-35-5, adjustments are often made to the instrument’s conversion price, which may have the effect of creating a new BCF if one has not been previously recorded, or may increase the intrinsic value of a previously recorded BCF.

ASC 470-20-25-6 provides guidance on the measurement of a contingent BCF.

**ASC 470-20-25-6**

A contingent beneficial conversion feature shall be measured using the commitment date stock price (see paragraphs 470-20-30-9 through 30-12) but, as discussed in paragraph 470-20-35-3, shall not be recognized in earnings until the contingency is resolved.

In some situations, it is not possible to measure a contingent BCF at the commitment date. For example, there may be a conversion feature that will be adjusted for the future issuance of shares at a price below the instrument’s original strike price, commonly referred to as a “down-round” provision. In such situations, the contingent BCF should be measured when the contingency is resolved.

When a contingent event occurs and an instrument either becomes convertible or the conversion price is adjusted, a reporting entity should recalculate the BCF using the current conversion price. If the newly calculated BCF amount exceeds the previously recorded BCF, the reporting entity should record the additional BCF amount as an increase to additional paid-in capital.

If an instrument’s conversion price increases so that the newly calculated BCF amount is less than the previously recorded BCF amount, the reporting entity should record the difference as a decrease to additional paid-in capital. However, any previously recognized amortization of the discount created by initially separating the BCF should not be reversed.

Example 7-3 illustrates how to measure and record a contingent BCF.

**EXAMPLE 7-3**

**Contingent BCF measurement and recognition**

FG Corp issues $1,000 of convertible preferred stock in exchange for $1,000 cash. FG Corp’s stock price on the date the instrument is issued, which is the commitment date, is $18 per share.

The convertible preferred stock has a stated conversion price of $20 at issuance; therefore, it is convertible into 50 shares of FG Corp’s common stock ($1,000 preferred stock / $20 conversion price). The terms of the instrument include a down-round provision, requiring the conversion price to be reduced for any subsequent at market issuance of shares at a price below the instrument’s original strike price.

One year after issuance, FG Corp issues shares at $13 per share, which is the then market price for its shares. Accordingly, FG Corp reduces the instrument’s conversion price to $13; therefore, it is convertible into 77 shares of FG Corp’s common stock ($1,000 preferred stock / $13 conversion price).

No BCF existed at inception as FG Corp’s stock price of $18 was less than the conversion price of $20.

When and how should FG Corp record the contingent BCF triggered by issuance of additional shares?
Analysis

The contingent BCF cannot be calculated until additional shares are issued; therefore, the contingent BCF should be measured and recorded when FG Corp issues the additional shares.

We believe the BCF amount should be calculated as the intrinsic spread between the adjusted effective accounting conversion price ($13) and the original commitment date market price ($18), multiplied by the new number of shares into which the security is legally convertible when the contingent event occurs (77 shares).

\[(18 - 13) \times 77 \text{ Shares} = $385\]

To record the BCF, FG Corp should record the following journal entry.

- Dr. Discount on convertible preferred stock $385
- Cr. Additional paid-in capital (BCF) $385

This approach to calculating a contingent BCF (the “intrinsic method”) is referenced in ASC 470-20-55-24. However, a literal read of ASC 470-20-35-1 would indicate that the BCF amount should be calculated by multiplying the additional shares to be received once the conversion price is adjusted by the commitment date stock price. In this example, this would result in a charge of $486 \([(77 \text{ shares} - 50 \text{ shares}) \times 18]\). These methods produce the same result when the original conversion option strike price is equal to the stock price at the commitment date (i.e., the option is at the money) but produce different results when the original conversion option strike price differs from the commitment date stock price. The approach described in ASC 470-20-35-1 would result in an inaccurate contingent BCF whenever the original conversion option is issued at other than at-the-money. For that reason, we believe that the intrinsic method is more reliable.

Resetting of a conversion option for a change in stock price

Some convertible instruments pay a fixed monetary amount to the investor upon conversion. To do this, the instrument’s conversion price is adjusted for increases or decreases in the fair value of the reporting entity’s stock. ASC 470-20-55-19 provides guidance for these instruments, which are in substance, stock-settled debt.

**ASC 470-20-55-19**

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, there is no beneficial conversion option and the convertible instrument would be considered stock-settled debt. However, if the conversion price does not fully reset (for example, resets on specified dates before maturity), the reset represents a contingent beneficial conversion feature subject to this Subtopic.

A reporting entity should assess the reset terms of its convertible instrument to determine whether it is stock-settled debt or a convertible instrument with a contingent BCF.
Amortization of the discount created by separating a BCF

The method of recognizing a discount created by separating a BCF, or contingent BCF, from convertible preferred stock depends on the terms of the convertible preferred stock. A BCF discount created in an equity instrument with a stated or mandatory redemption date should be amortized over the period from the issuance date through the stated maturity or redemption date using the interest method. The amortization should be accounted for as a deemed dividend, provided the preferred stock is classified as equity.

Discounts created by separating a BCF from perpetual convertible preferred stock should be amortized over the period from the issuance date through the first date the investor can exercise the conversion option (i.e., the first conversion date) using the interest method. If preferred stock is immediately convertible, the discount should be amortized all at once upon issuance.

If the convertible preferred stock is redeemable (1) at the option of the investor or, (2) upon the occurrence of an event that is not within the reporting entity’s control, we believe the BCF discount may be accreted over a period of time from the issuance date through (1) the first conversion date, or (2) the first put date. The amortization should be accounted for as a dividend, provided the preferred stock is classified as equity.

7.3.3 Evaluate put and call options

Due to the higher cost of issuing preferred stock, it is often callable by the issuer after a certain period (e.g., after five years). In addition, put options provide shareholders liquidity and protection upon the occurrence of specified events. For example, a put option exercisable upon “a fundamental change” may be included to give shareholders the ability to redeem their shares in certain circumstances.

Put and call options may affect the classification of preferred stock as mezzanine or permanent equity. See FG 7.3.4 for further information. An issuer should also consider whether any put or call options embedded in preferred stock should be separated and accounted for as a derivative under the guidance in ASC 815. See DH 4.4.3 for information on put and call options embedded in an equity instrument.

7.3.4 Assess whether preferred stock should be classified as mezzanine or permanent equity

Provided preferred stock is not classified as a liability based on the guidance in ASC 480, a reporting entity should assess whether its preferred stock should be classified as mezzanine or permanent equity. Under the SEC rules, redeemable instruments should be presented outside of permanent equity in what is generally called the mezzanine (or temporary) equity section. The purpose of mezzanine equity classification is to convey to the financial statement users that the preferred stock may not be permanently part of equity and could result in a demand for cash or other assets of the reporting entity in the future.

For SEC registrants, ASC 480-10-S99 requires preferred stock redeemable for cash or other assets to be classified outside of permanent equity (in the mezzanine or temporary equity section), if it is redeemable:

- At a fixed or determinable price on a fixed or determinable date
- At the option of the shareholder
Upon the occurrence of an event that is not solely within the control of the reporting entity

Preferred stock with redemption at a fixed or determinable date can be classified as equity if it has a substantive conversion option. See FG 7.3.1.1 for further information.

Although technically not required for private entities, mezzanine equity presentation is strongly encouraged, especially in those circumstances when there is not a high likelihood that the capital is in fact permanent, e.g., when preferred stock is redeemable at the option of the holder at any time. On the other hand, use of a mezzanine presentation may be less relevant in other circumstances, such as when preferred stock is redeemable by the holder only upon the occurrence of a remote event. If mezzanine presentation is not elected, separate presentation from other items within equity should be considered.

If preferred stock classified as mezzanine equity is no longer required to be presented in mezzanine equity (e.g., due to the expiration of a redemption feature) it should be reclassified to permanent equity. The carrying amount of the preferred stock should not be adjusted upon the reclassification to permanent equity.

As discussed in ASC 480-10-S99-3A(4), it is not appropriate to classify preferred stock that meets the requirements for classification in temporary equity as a liability.

### 7.3.4.1 Contingently redeemable preferred stock

Preferred stock that, by its terms, is contingently redeemable upon the occurrence of an event that is outside of the issuer’s control should be classified as mezzanine equity based on ASC 480-10-S99. The probability that the redemption event will occur is irrelevant, as discussed in ASC 480-10-S99-3A5.

**ASC 480-10-S99-3A5**

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.

Figure 7-5 lists common redemption provisions that may cause preferred stock to be classified as mezzanine equity.

**Figure 7-5**

<table>
<thead>
<tr>
<th>Redemption event</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delisting</td>
<td>Preferred stock is redeemed in the event the issuer is delisted from trading on any stock exchange on which it is listed</td>
</tr>
<tr>
<td>Decline in credit rating</td>
<td>Preferred stock is redeemed in the event the issuer’s credit rating is reduced</td>
</tr>
<tr>
<td>Redemption event</td>
<td>Description</td>
</tr>
<tr>
<td>-------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Change of control</td>
<td>Preferred stock is redeemed in the event of a change in control of the reporting entity, or due to a merger, consolidation, or other deemed liquidation event.</td>
</tr>
<tr>
<td>Failure to complete an IPO</td>
<td>Preferred stock is redeemed if the issuer fails to complete an IPO by a stated date. Completion of an IPO by a specified date is outside the issuer’s control.</td>
</tr>
<tr>
<td>Failure to have a registration statement declared effective</td>
<td>Preferred stock is redeemed if the issuer fails to have a registration statement declared effective by a stated date. However, if there is no specified date or time period, the ability to have the registration declared effective is considered within the issuer’s control, and therefore permanent equity classification would be permitted.</td>
</tr>
<tr>
<td>Lapsed registration statement</td>
<td>Preferred stock is redeemed in the event an effective registration statement lapses.</td>
</tr>
<tr>
<td>Failure to make timely SEC filings</td>
<td>Preferred stock is redeemed in the event the issuer fails to make timely SEC filings. As stated in ASC 815-40-25-29 in the context of derivatives and hedging, the ability to make timely SEC filings is not within the issuer’s control.</td>
</tr>
<tr>
<td>Failure to pay dividends</td>
<td>Preferred stock is redeemed in the event the issuer fails to pay dividends. The ability to pay dividends may depend on the attainment of certain results (e.g., operating performance) or be restricted by the terms of loans or other securities, and therefore may not be within the issuer’s control.</td>
</tr>
<tr>
<td>Failed Dutch Auction</td>
<td>Preferred stock sold through a Dutch Auction (auction starting with a high asking price that is subsequently lowered until a bid is made) is redeemable when there are insufficient buyers resulting in a failed auction.</td>
</tr>
<tr>
<td>Failure to sell an asset or division</td>
<td>Preferred stock is redeemable in the event the issuer fails to sell an asset or division by a certain date.</td>
</tr>
<tr>
<td>Covenant violations</td>
<td>Preferred stock is redeemed in the event the issuer (1) has a debt covenant violation, or (2) fails to meet a net income covenant (even if current projections indicate the occurrence of these events is remote)</td>
</tr>
<tr>
<td>Redemption event</td>
<td>Description</td>
</tr>
<tr>
<td>------------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Key man death</td>
<td>Preferred stock is redeemable in the event of the death or disability of the CEO or other key management member, and the redemption is at the option of the shareholder’s heir or estate. In event the redemption will be funded from the proceeds of an insurance policy that is currently in force and that the issuer has the intent and ability to maintain in force, permanent equity classification may be permitted.</td>
</tr>
</tbody>
</table>

**Ordinary liquidation events vs. deemed liquidation events**

An instrument redeemable upon ordinary liquidation events generally do not result in an instrument being classified as mezzanine equity. An instrument that is redeemable upon a deemed liquidation event, however, will often be classified as mezzanine equity. The SEC staff provides guidance on whether provisions related to a deemed liquidation event should result in a security being classified as mezzanine equity in ASC 480-10-S99-3A(f).

**ASC 480-10-S99-3A3(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 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 subordinate 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).

In our experience, the exception discussed in ASC 480-10-S99-3A(f) is rarely applicable. Some preferred stock agreements provide for the distribution of proceeds in the event of a deemed liquidation event (which often includes change in control) in accordance with the liquidation preferences applicable to an ordinary liquidation. Unless all holders of equally and more subordinated equity instruments would always be entitled to also receive the same form of consideration, we believe an instrument with this provision should be classified as mezzanine equity. In other words, for a preferred share to be classified as permanent equity, there can be no possible scenario in which the preferred shareholders receive consideration and the holders of equally or more subordinate securities would not receive consideration in proportion to their holdings.
Question 7-10 discusses whether preferred stock should be classified as mezzanine or permanent equity if it is redeemable upon a deemed liquidation event outside of the reporting entity’s control.

**Question 7-10**

An SEC registrant issues preferred stock that is redeemable at a stated dollar amount upon the sale, liquidation, or dissolution of the reporting entity. In addition, the preferred stock agreement states that the acquisition of the reporting entity in which the former shareholders of the reporting entity will own less than 50% of the voting power of the surviving entity will be deemed a sale of the reporting entity.

The reporting entity’s articles of incorporation state that its board must approve all mergers, consolidations, sales, liquidations, or dissolutions of the reporting entity. The preferred shareholders do not control the reporting entity’s board.

Should the preferred stock be classified as mezzanine or permanent equity?

**PwC response**

The preferred stock should be classified as mezzanine equity. The shares are redeemable upon a deemed liquidation event. Since only the preferred stock (and not the common stock) will be redeemed upon the occurrence of the deemed liquidation event, and the event is not within the reporting entity’s control, the preferred stock should be classified as mezzanine equity.

To determine whether a deemed liquidation provision causes an instrument to be classified as mezzanine equity, a reporting entity must have a thorough understanding of the instrument-specific definition of deemed liquidation and all of the related redemption provisions. In some cases, the reporting entity’s governing documents or state law may require approval by the board of directors before any merger or consolidation can occur. Some might conclude that an instrument with this provision should be classified as permanent equity; however, there are often a number of other contractual “deemed liquidation events” that trigger redemption (e.g., squeeze-out mergers, hostile asset sales) that do not require board approval and thus are considered outside the control of the issuer. In that case, the preferred shares should be classified as mezzanine equity. As this is a legal determination, reporting entities should consult their legal counsel. See ASC 480-10-S99-3A8 for an example in which the SEC illustrates this point.

As stated in ASC 480-10-S99-3A5, the assessment of whether a triggering event is within the control of a reporting entity should be made without regard to the probability of that event occurring.

**ASC 480-10-S99-3A8**

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.
**Liquidated damages**

The terms of preferred stock may require an issuer to pay liquidated damages upon the occurrence or nonoccurrence of an event outside its control. The payment may be a significant percentage of the preferred stock proceeds. The payment of liquidated damages does not result in a legal redemption or settlement of the preferred stock; therefore, a liquidated damages provision does not cause preferred shares to be classified as mezzanine equity. However, a liquidated damages provision could be an embedded derivative that should be accounted for separately. See DH4 for information on embedded derivatives.

### 7.3.4.2 Convertible preferred stock

Contractual features, in convertible preferred stock or in the instruments into which the preferred stock may be converted, may result in the shares being classified as mezzanine equity. Figure 7-6 lists common features that may cause convertible preferred stock to be classified as mezzanine equity. A reporting entity should also consider the points discussed in FG 7.3.4.1 for contingently redeemable preferred stock and in FG 7.3.4.3 for perpetual preferred stock.

**Figure 7-6**
Common features that may result in mezzanine equity classification

<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redemption upon conversion default</td>
<td>Convertible preferred stock is redeemed in the event the issuer cannot deliver the conversion shares because (1) it does not have an adequate number of shares authorized and must seek shareholder approval for an increase to the number of authorized shares (even if the terms require that common shares be reserved for conversion and the need for an increase in authorized shares to satisfy conversion is deemed remote) or (2) delivery of the conversion shares under any circumstances would result in dilution of 20% or more of the outstanding shares of common stock, which under certain stock exchange rules requires shareholder approval prior to issuance of the conversion shares.</td>
</tr>
<tr>
<td>Preferred shares exchangeable into shares of an equity-method investee or other assets</td>
<td>Preferred stock is exchangeable into preferred stock of an equity-method investee of the issuer, without regard to whether the equity-method investee is a private or public entity. Preferred shares that are redeemable for cash or other assets should be reported as mezzanine equity, even when the assets to be received are not readily convertible into cash.</td>
</tr>
<tr>
<td>Preferred shares convertible into mandatorily redeemable common stock</td>
<td>Preferred stock convertible into mandatorily redeemable common stock is classified as mezzanine equity because conversion of the preferred stock and redemption of the resultant common stock are both outside of the issuer's control. Once the preferred stock is converted, redemption of the common stock is certain to occur, so the common stock should be classified as a liability under the guidance in ASC 480.</td>
</tr>
</tbody>
</table>
### 7.3.4.3 Perpetual preferred stock (no redemption)

In general, perpetual preferred stock is classified as permanent equity. However, perpetual preferred stock may be classified as mezzanine equity if the preferred shareholders control the board of directors (or could control the board as a result of events outside the reporting entity’s control, such as a debt default) and the preferred stock contains a call option exercisable at the reporting entity’s discretion. In that case, the preferred shareholders would be able to force the reporting entity to redeem their shares for cash. In this case, mezzanine equity presentation would be appropriate.

### 7.4 Preferred stock recognition and measurement

Preferred stock should be recognized on its settlement date (i.e., the date the proceeds are received and the shares are issued) and is generally recorded at fair value. When preferred shares are sold in a bundled transaction with other instruments, such as warrants, the proceeds received should be allocated to the preferred stock and other instruments issued. How the proceeds are allocated depends on the accounting classification of the other instruments issued. See FG 8.3.1 for information on warrants issued with preferred stock.

If preferred stock is sold using an escrow arrangement in which cash is deposited in an escrow account for the purchase of the shares, the issuer should determine who owns the escrow account in the event of the investor’s bankruptcy. If the investor’s creditors have access to the escrow cash in the event of its bankruptcy, the cash held in escrow should not be recorded on the issuer’s balance sheet, and the preferred stock subject to the escrow account should not be recorded until the escrowed cash is legally transferred to the issuer and the shares are delivered to the investor.

Preferred shares may be sold for future delivery through a forward sale contract. In a forward sale contract, the investor is obligated to buy (and the reporting entity is obligated to sell) a specified number of the reporting entity’s shares at a specified date and price. See FG 8.2.1 for information on forward sales of a reporting entity’s own equity securities.

### 7.4.1 Participation rights

One of the main disadvantages of preferred stock compared to common stock is its limited potential to benefit from increases in earnings. A participation right allows a preferred shareholder to receive additional income when dividends are paid to common shareholders.

If a preferred share is determined to be more akin to equity than debt, a participation right is considered clearly and closely related to the host equity instrument. If the preferred stock is more akin

---

<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible preferred stock when the issuer does not control share settlement of conversion option</td>
<td>The guidance in ASC 815-40-25 should be used to evaluate whether the issuer controls the actions or events necessary to issue the number of required shares under the conversion option if exercised by the holder. If the issuer does not control share settlement of the conversion option embedded in convertible preferred stock, then cash settlement of the conversion option would be presumed and the convertible preferred stock would be classified as temporary equity.</td>
</tr>
</tbody>
</table>
to debt, the participation right should be analyzed to determine if it should be separated and accounted for as a derivative under the guidance in ASC 815. See FG 7.3.2 for information on determining the nature of a host instrument, and see DH 4 for information on determining whether an embedded component should be separately accounted for as a derivative under the guidance in ASC 815.

In addition, the inclusion of a participation right generally requires the issuer to include the instrument in earnings per share using the two-class method. See FSP 7.4.2 for information on determining the nature of a host instrument, and see DH 4 for information on determining whether an embedded component should be separately accounted for as a derivative under the guidance in ASC 815.

7.4.2 **Stock issuance costs**

The accounting for stock issuance costs depends on how the shares are classified on the balance sheet. The Figure 7-7 summarizes the accounting for stock issuance costs.

**Figure 7-7**

**Accounting for stock issuance costs**

<table>
<thead>
<tr>
<th>Classification</th>
<th>Accounting for stock issuance costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanent equity</td>
<td>Issuance costs are recorded as a reduction of the share balance/additional paid-in capital</td>
</tr>
<tr>
<td>Mezzanine equity</td>
<td>Issuance costs are recorded as a reduction of the share balance</td>
</tr>
<tr>
<td>Liability</td>
<td>Issuance costs are treated in the same manner as debt issuance costs. See FG 1.2.2 for a discussion of debt issuance costs</td>
</tr>
</tbody>
</table>

We believe issuance costs related to shares classified as a liability that must be accounted for at fair value (with changes in fair value recorded in the income statement) should be immediately expensed.

When state regulations prohibit charging stock issuance costs to the share balance or additional paid-in capital, they may be charged to retained earnings. See FG 1.2.2 for information on qualifying issuance costs.

Question 7-11 discusses how a reporting entity should account for transaction costs paid on behalf of existing investor in relation to the sale of shares to a new investor.

**Question 7-11**

FG Corp has 120 shares outstanding owned equally by three investors. A new investor, Investor Corp, agrees to acquire 20 FG Corp shares from each of the existing investors. In connection with the transaction FG Corp agrees to reimburse the existing investors for the transaction costs related to the share sale.

How should FG Corp account for the transaction costs it pays on behalf of the existing shareholders?
PwC response

The sale of shares from the existing shareholders to Investor Corp does not raise capital and therefore it would be appropriate for FG Corp to expense the transaction costs it pays on behalf of the existing shareholders. However, when all shareholders participate in the sale transaction, it may also be appropriate to record the payment as a dividend, depending on the facts and circumstances of the transaction. See FG 7.7 for information on preferred stock dividends.

7.4.3 Subsequent measurement of preferred stock

The carrying amount of preferred stock may be recorded at a discount to its redemption price. The amount the issuer must pay to redeem a preferred share may be greater than the amount at which the preferred stock was initially recorded for the following reasons:

- The preferred stock is issued in a bundled transaction with other instruments (e.g., warrants); the proceeds received by the issuer are allocated to the preferred stock and the other instruments issued
- Stock issuance costs are recorded as a reduction of the preferred stock balance
- The redemption price includes cumulative dividends whether declared or undeclared

The accounting for a preferred stock discount depends on the classification of the preferred stock and the terms of the redemption provision. See the following sections for further information.

If amortization of a preferred stock discount is required, the amortization amount should be recorded as a deemed dividend, which adjusts retained earnings (or in the absence of retained earnings, additional paid-in capital) and earnings available to common shareholders in calculating basic and diluted earnings per share.

7.4.3.1 Mandatorily redeemable preferred stock classified as a liability under ASC 480

ASC 480-10-35-3 provides guidance on the subsequent measurement of mandatorily redeemable instruments classified as liabilities.

Excerpt from ASC 480-10-35-3

[M]andatorily 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.

See FG 1.2.3 for information on the amortization of debt discount, premium, and issuance costs.
7.4.3.2 *Mandatory redeemable preferred stock classified as mezzanine equity*

The SEC has provided guidance on the subsequent measurement of mandatorily redeemable instruments classified as mezzanine equity. The guidance is codified in ASC 480-10-S99-3A

**ASC 480-10-S99-3A14**

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).

**ASC 480-10-S99-3A15**

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:

a. 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.

b. 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.

A reporting entity should consider the nature of an instrument’s redemption provisions when choosing the appropriate accretion method. We believe a reporting entity should use a method that most closely reflects the underlying economics of the instrument. For example, it may be appropriate for a preferred share redeemable at a fixed date for a fixed amount to be accreted using the method described in ASC 480-S99-10-3A-15a; however, a preferred share redeemable for a variable amount may be more appropriately measured using the method described in ASC 480-S99-10-3A-15b.

Question 7-12 discusses whether preferred stock that is both redeemable on a specified date and automatically convertible in the event of an IPO is considered probable of becoming redeemable.
Question 7-12
Is preferred stock that is both redeemable on a specified date and automatically convertible in the event of an IPO considered probable of becoming redeemable?

PwC response
Maybe. We believe that the probability of the IPO occurring should be considered when determining whether the preferred stock is probable of becoming redeemable. Given the subjective nature of this determination, all relevant facts and circumstances should be considered.

If the preferred stock is redeemable at the option of the holder on a specified date and convertible at the option of the holder in the event of the IPO, it is inappropriate to consider the probability of the IPO occurring because the exercise of the option is controlled completely by the holder. In this case, the preferred stock should be considered probable of becoming redeemed.

7.4.3.3 Mandatorily redeemable preferred stock of a subsidiary

If a subsidiary’s preferred stock is classified as a liability in the consolidated balance sheet (e.g., pursuant to the guidance in ASC 480), the dividends and any changes in the carrying amount of the liability should be recorded as interest expense in the consolidated income statement.

If a subsidiary’s preferred stock is classified as equity in the consolidated balance sheet, ASC 810-10-40-2 requires the parent to record the dividends as an allocation of net income to the noncontrolling interest. Accordingly, net income should not be reduced by dividends on the preferred stock, but net income attributable to the parent (which is the starting point for the earnings per share numerator) should be reduced by the amount of the dividend.

Example 7-4 illustrates the accounting for mandatorily redeemable preferred stock of a subsidiary.

EXAMPLE 7-4

Redeemable preferred stock of a subsidiary

FG Corp owns 100% of the outstanding common stock of Sub Co. Sub Co has 100,000 shares of noncumulative preferred stock issued and outstanding, which pays a stated annual dividend rate of 5%. The preferred shares are owned by unrelated parties and have a recorded value of $200,000. FG Corp analyzed the terms of Sub Co’s preferred shares and concluded that the shares should be accounted for as equity in FG Corp’s consolidated financial statements.

In the current year, Sub Co pays the stated annual dividend of $10,000 (5% × $200,000). At the end of the year, Sub Co redeemed its preferred stock for $225,000.

FG Corp has consolidated income before tax and noncontrolling interest of $100,000, and income tax expense of $35,000.

How should the Sub Co’s preferred stock dividend and redemption be presented in FG Corp’s consolidated income statement?
Analysis

Since the Sub Co preferred shares are classified as equity in the FG Corp consolidated financial statements, dividends should be recorded as income attributable to the noncontrolling interest. The total dividend amount during the period is $35,000; $10,000 of preferred share dividends, and a $25,000 deemed dividend upon the redemption of the shares ($225,000 redemption amount less $200,000 carrying amount).

The dividend on Sub Co’s preferred shares would be included in FG Corp’s consolidated income statement as shown below.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before tax</td>
<td>$100,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>$65,000</td>
</tr>
<tr>
<td>Net income attributable to the noncontrolling interest</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Net income attributable to parent</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

7.4.3.4 Contingently redeemable preferred stock

A discount to the redemption amount of a contingently redeemable preferred share should be amortized only once it is probable the share will become redeemable. If it is not probable that the preferred share will become redeemable (and as a result, any discount to the preferred share carrying amount is not amortized), a reporting entity should disclose why redemption is uncertain.

Once redemption is probable, the carrying amount of the preferred stock should be accreted to its redemption value. A contingently redeemable preferred share that is redeemable only at the reporting entity’s option should not be adjusted.

Figure 7-8 lists common redemption provisions and whether the preferred stock carrying amount should be adjusted.

Figure 7-8

Accounting for a discount to the redemption amount of preferred stock

<table>
<thead>
<tr>
<th>Redemption provision</th>
<th>Accounting for preferred stock discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redeemable (puttable) at the investor’s option</td>
<td>The carrying amount of the preferred stock should be adjusted to its redemption amount at each balance sheet date. Any discount should be recognized over the period from issuance to the date the preferred stock can first be redeemed. However, the carrying amount should not be adjusted to an amount that is less than the initial carrying amount. For this reason, a premium to the redemption amount should not be amortized.</td>
</tr>
</tbody>
</table>
A reduction in the carrying amount of a preferred share should be recorded only to the extent the reporting entity previously recorded increases in the carrying amount. The redemption price of a preferred share should not be adjusted below its initial carrying amount.

An issuer should also apply the guidance in Figure 7-8 to determine whether unpaid cumulative dividends included in the redemption amount of contingently redeemable preferred stock should be accrued. If cumulative undeclared dividends are included in the redemption price of preferred stock that is not being adjusted, then the dividends should not be recorded until they are declared. A reporting entity should determine how to reflect preferred stock dividends in earnings per share independent from its accounting for cumulative preferred stock dividends. In most cases, a reporting entity’s earnings per share computations should reflect undeclared dividends related to cumulative preferred stock. See FSP 7.4 for information on including preferred stock dividends in earnings per share.

If the carrying amount of a preferred share of stock is adjusted for amortization of a discount (or for accrued but unpaid dividends), the adjustment should be recorded as a deemed dividend, which reduces retained earnings (or in the absence of retained earnings, additional paid-in capital) and earnings available to common shareholders in calculating basic and diluted earnings per share.

### Perpetual preferred stock (no redemption)

Perpetual preferred stock is carried at the amount recorded at inception. There is no requirement to carry perpetual preferred stock at its liquidation value; therefore, any discount or premium to the redemption amount should not be amortized. Similarly, cumulative undeclared dividends included in the redemption price of perpetual preferred stock should not be recorded until they are declared.

A reporting entity should determine how to reflect preferred stock dividends in earnings per share independent from its accounting for cumulative preferred stock dividends. In most cases, a reporting entity’s earnings per share computations should reflect undeclared dividends related to cumulative preferred stock. See FSP 7.4 for information on including preferred stock dividends in earnings per share.
7.5 Increasing rate preferred stock

Some preferred shares have a dividend that increases upon the passage of time or upon the occurrence of an event outside of the reporting entity’s control. Although there may not be a requirement to declare dividends, dividends on cumulative preferred stock should be deducted from earnings available to common shareholders when calculating basic and diluted earnings per share, even if undeclared. As a result, a reporting entity may have an economic incentive to redeem increasing rate preferred stock to avoid the increase in the dividend rate.

The SEC staff addresses the accounting for certain nonredeemable (defined as shares that are not redeemable or redeemable only at the option of the issuer) increasing rate preferred stock in SAB Topic 5Q, which is codified in ASC 505-10-S99-7.

Excerpt from ASC 505-10-S99-7

Facts: A registrant issues Class A and Class B nonredeemable preferred stock 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.

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 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. 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.
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 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).

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:

<table>
<thead>
<tr>
<th></th>
<th>Beginning of year (BOY)</th>
<th>Imputed dividend (8% of carrying amount at BOY)</th>
<th>End of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 20X1</td>
<td>79.38</td>
<td>6.35</td>
<td>85.73</td>
</tr>
<tr>
<td>Year 20X2</td>
<td>85.73</td>
<td>6.86</td>
<td>95.29</td>
</tr>
<tr>
<td>Year 20X3</td>
<td>95.29</td>
<td>7.41</td>
<td>100.00</td>
</tr>
</tbody>
</table>

During 20X4 and thereafter, the stated dividend of $8 measured against the carrying amount of $100 would reflect dividend cost of 8%, the market rate at time of issuance.

In contrast to the guidance in ASC 505-10-S99-7, if preferred shares are issued at the redemption amount, dividends should be accrued based on the payment schedule rather than amortized over the life. This is illustrated in Question 7-13.

**Question 7-13**

A reporting entity issues perpetual preferred stock and receives proceeds equal to the redemption amount of the shares. The preferred stock pays an at-market cumulative dividend at a rate of 6% for the first five years and a dividend rate of 25% thereafter.

The preferred shares contain a call option that allows the reporting entity to call the preferred shares at par value at the end of year five before the dividend rate increases.

Are the preferred shares considered perpetual? How should the reporting entity accrue the dividends on the increasing rate preferred stock?
**PwC response**

The shares are perpetual. The shares are not redeemable even though the reporting entity may have an economic incentive to redeem them before the dividend rate increases. The reporting entity should classify the preferred shares as permanent equity. Mezzanine equity classification is not appropriate since the investor cannot force the reporting entity to redeem the shares.

Since the shares initially pay an at-market dividend and are not issued as a discount, the dividends should be accrued based on the payment schedule. Therefore, the reporting entity should accrue 6% per share for the first five years and 25% thereafter until it calls the preferred stock and redeems it.

### 7.6 Tranched preferred stock

A tranched preferred stock issuance is one in which preferred stock is issued with a simultaneous contractual commitment, which either (1) requires the reporting entity to issue additional series at a future date or upon occurrence of a specified milestone or (2) gives investors the option to require the reporting entity to issue additional series at a future date or upon occurrence of a specified milestone.

From the investor’s perspective, tranched financing defers a portion of the cash funding. Milestones align the commitment of funds to the reporting entity’s performance. From the issuer’s perspective, tranched preferred stock reduces fundraising efforts and funding risk if the milestones are achieved.

The issuer should determine whether the commitment to issue preferred stock in the future is a freestanding instrument or a component embedded in the initial issuance. The ASC Master Glossary provides a definition of a freestanding financial instrument.

#### Definition from ASC Master Glossary

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.

Since the commitment to issue shares is typically entered into in connection with the issuance of the first tranche of preferred stock, an issuer should consider the provisions in (b) above by answering the following questions.

- Are the first tranche of preferred stock and the commitment to issue shares legally detachable?
- Are the first tranche of preferred stock and the commitment to issue shares separately exercisable?

As discussed in FG 5.3, we believe separate exercisability is a strong indicator that a component is freestanding because a component must first be detached from its host instrument (i.e., the preferred stock) before it can be separately exercised. However, some issuers put more weight on whether the commitment to issue shares is legally detachable from the first tranche of preferred stock when determining whether it is freestanding or embedded. Generally, if the transaction documents do not
specifically state that the commitment cannot be transferred separate from the preferred stock, the commitment is considered freestanding. See FG 5.3 for additional information on determining whether an instrument is freestanding or embedded.

An issuer’s accounting for the commitment to issue shares may differ if it is a freestanding instrument versus embedded in the preferred stock.

7.6.1 **Commitment to issues shares is a freestanding instrument**

If a commitment to issue shares is a freestanding instrument, the issuer should determine the appropriate classification of that freestanding commitment. The classification affects the methodology for allocating the proceeds received to the originally issued preferred stock and the commitment to issue shares.

The commitment to issue shares should first be evaluated to determine whether it is a liability within the scope of ASC 480. See FG 5.5 for information on ASC 480. If it is not within the scope of ASC 480, it should be evaluated using the model for freestanding equity-linked instruments discussed in FG 5.6.

If an issuer determines that a commitment to issue shares should be classified as equity, the proceeds from the original issuance should be allocated to the originally issued preferred stock and the commitment to issue shares using the relative fair value method. The commitment to issue shares should not be subsequently remeasured if it is classified as equity.

If an issuer determines that a commitment to issue shares should be classified as a derivative, the proceeds from the original issuance should be first allocated to that commitment at fair value, with any remainder allocated to the originally issued preferred shares. The commitment to issue shares should be subsequently recorded at fair value with changes in fair value recorded in the income statement.

If the commitment to issue shares does not meet the requirements for equity classification and does not meet the definition of a derivative, the issuer should apply appropriate US GAAP. See FG 5.6, FG 8.2.2.1, and FG 8.2.2.2 for further information.

The allocation of value to a commitment to issue shares may create a discount from the redemption amount of the originally issued preferred shares, which may have to be amortized. See FG 7.4.3 for information on the subsequent measurement of preferred stock, including the amortization of a discount.

7.6.2 **Commitment to issue shares is an embedded component**

If the commitment to issue shares is an embedded component, it should be evaluated to determine whether it should be separated and accounted for as a derivative based on the guidance in ASC 815. See FG 5.4 for the model for analyzing embedded equity-linked components. If an embedded commitment to issue shares should be separated and accounted for as a derivative, a discount from the redemption amount of the preferred stock will be created, which may have to be amortized. See FG 7.4.3 for information on the subsequent measurement of preferred stock, including the amortization of a discount.
### Preferred stock dividends

Noncumulative dividends on preferred stock generally do not accrue to the preferred shareholders until declared by the board of directors. The exception is when a preferred share requires the issuer to pay a periodic dividend even without a declaration by the board of directors. When noncumulative dividends are discretionary, they should be recorded when they are declared. When the issuer is legally obligated to pay dividends, they should be accrued as they are earned. Noncumulative dividends, generally, do not add to the liquidation or redemption value of the preferred share.

Cumulative dividends on preferred stock may accrue over time or upon the occurrence of an event (e.g., the attainment of cash flow goals or profitability levels). If the preferred shareholders do not receive a dividend (the board of directors does not declare a dividend) in a given period, then the undeclared dividend is accumulated. The reporting entity is obligated to pay any accumulated undeclared dividends upon liquidation and, in some cases, upon early redemption of the preferred share. Some preferred shares require the issuer to pay a periodic dividend even without a declaration by the board of directors. When cumulative dividends can be accumulated (or deferred), they should be recorded when they are declared or when accretion to the redemption amount is otherwise required. Alternatively, when the issuer is legally obligated to pay cumulative dividends, they should be accrued as they are earned.

When preferred shareholders participate in dividends with common shareholders, the two-class method of calculating earnings per share may be applicable. See FSP 7.4.2 for information on participating securities and the two-class method of calculating earnings per share.

A reporting entity should determine how to reflect preferred stock dividends in earnings per share independent from its accounting for cumulative preferred stock dividends. In most cases, a reporting entity’s earnings per share computations should reflect accrued undeclared dividends related to cumulative preferred stock. See FSP 7.4 for information on including preferred stock dividends in earnings per share.

See FG 4.4 for additional information on dividends.

Question 7-14 addresses whether cumulative dividends should be recorded as an increase to the carrying amount of preferred stock even when not declared.

#### Question 7-14

A reporting entity issues preferred stock that pays cumulative dividends and is redeemable at the shareholder’s option after four years. The redemption price is equal to the original issue price plus the cumulative dividends, whether or not declared. The reporting entity classifies the preferred stock in mezzanine equity because it is not mandatorily redeemable (i.e., the holders may or may not exercise the redemption right) but redemption is outside of the reporting entity’s control.

Should dividends be recorded as an increase to the carrying amount of the preferred stock even when not declared?

#### PwC response

Yes. The terms of the preferred stock require the reporting entity to pay the original issue price of the preferred stock plus cumulative dividends, whether or not declared, upon redemption. Therefore, the
Preferred stock

reporting entity is legally obligated to pay the dividends. As such, dividends should be recorded as an increase to the carrying amount of the preferred stock even when there has been no dividend declaration.

7.7.1  **Stock dividends**

When a stock dividend on preferred shares is paid in another class of stock, the reporting entity should record the fair value of the shares issued in retained earnings. See FG 4.4.4.1 for further information. As discussed in ASC 260-10-45-12, dividends declared on preferred stock that are payable in the reporting entity’s common shares should be deducted from earnings available to common shareholders when computing earnings per share. Accordingly, an adjustment to net income for preferred stock dividends is required regardless of the form of the payment (whether the dividend is paid in cash, common shares, or additional preferred shares of the same or another class).

7.8  **Preferred stock modifications**

There is no specific guidance on whether a modification to, or exchange of, preferred stock should be accounted for as a modification or an extinguishment. Many preferred stock modifications do not involve changes in cash flows, but may result in a significant change to the fair value of the security, such as a change in the liquidation preference order/priority, voting rights, or conversion ratio. As such, the accounting for preferred stock modifications depends on the facts and circumstances of each transaction, including the nature of, and reasons for, the modification.

7.8.1  **Determining whether a modification should be accounted for as a modification or an extinguishment**

When a reporting entity changes the terms of its preferred stock or exchanges one preferred share for another, it must assess whether the changes or exchange should be accounted for as either a modification or extinguishment. This assessment can be done either qualitatively or quantitatively. A qualitative assessment is generally appropriate when the changes to a preferred stock instrument are either so inconsequential or so significant that a reporting entity can easily determine how a change to or exchange of shares should be accounted for without performing a quantitative test. For example, administrative changes to a preferred stock would likely be accounted for as a modification; a modification of a preferred share to include a substantive conversion option would generally be accounted for as an extinguishment of the original preferred stock and issuance of new preferred stock. When preferred stock is modified in a manner that cannot be reliably assessed qualitatively, a reporting entity should perform a quantitative test to determine whether the modification or exchange should be accounted for as a modification or an extinguishment.

When a preferred share has well-defined periodic contractual cash flows, an issuer may apply the cash flow model used to assess debt modifications in ASC 470-50, *Debt – Modifications and Extinguishments*, to determine whether a modification or exchange of a preferred share should be accounted for as a modification or extinguishment. Under that model, an issuer would compare the present value of the contractual cash flows (calculated using the effective interest rate of the original instrument) before and after a modification or exchange. If the present value of the contractual cash flows differs by more than 10%, the modification or exchange is accounted for as an extinguishment; if the present value of the contractual cash flows differs by less than 10%, the modification or exchange is accounted for as a modification. See FG 3.4 for further information on the cash flow model in ASC 470-50.
If a preferred share has characteristics that cannot be reliably assessed using the cash flow model in ASC 470-50, it should be evaluated using another quantitative model, such as the fair value model. Under the fair value model, a reporting entity would compare the fair value of the preferred shares immediately before and after the modification or exchange. If the fair value before and after the modification or exchange are substantially different, the modification or exchange should be accounted for as an extinguishment; if the fair value before and after the modification or exchange are not substantially different, it should be accounted for as a modification. In practice, “substantially different” has typically been interpreted to be a 10% change in fair value.

Question 7-15 asks whether the redemption of an existing preferred share and issuance of a new preferred share to the same investors should automatically be accounted for as an extinguishment.

**Question 7-15**

If an issuer redeems an existing preferred share and issues a new preferred share to the same investors (e.g., exchanges Series A preferred stock for Series B preferred stock), should it be automatically accounted for as an extinguishment?

**PwC response**

No. The legal extinguishment of an existing preferred share that is replaced with a new preferred share does not automatically result in extinguishment accounting. An issuer should assess, using one of the methods described in this section, whether the exchange should be accounted for as a modification or an extinguishment.

**7.8.2 Accounting for a preferred stock modification**

If the assessment results in an extinguishment, then the difference between the consideration paid (i.e., the fair value of the new or modified preferred shares) and the carrying value of the original preferred shares should be recognized as a reduction of, or increase to, retained earnings as a deemed dividend. It should also be recognized as an adjustment to earnings available to common shareholders for purposes of calculating earnings per share. See FG 7.10 for information on the extinguishment of preferred stock.

If an issuer determines that an exchange or modification of preferred stock should be accounted for as a modification, it should then evaluate whether the original preferred shareholders paid or received a dividend through the new (or modified) terms. The issuer should measure any transfer of value between preferred shareholders and common shareholders by analogizing to the guidance for stock-based compensation arrangements classified as equity in ASC 718-20-35-3 as the difference between the fair value of the preferred shares before and after the modification or exchange, measured on the modification or exchange date. Transfers of value should be recorded as a reduction of, or increase to, retained earnings as a deemed dividend. In addition, it should also be recognized as an adjustment to earnings available to common shareholders for purposes of calculating earnings per share.

Some modifications of preferred stock may occur in connection with the issuance of new preferred stock. For example, when outstanding preferred stock is modified concurrent with the sale of new preferred stock, the modification may reflect concessions made by existing preferred stockholders regarding their rights in order to attract the new capital. The new preferred stockholders may insist on such concessions as a condition of their investment to avoid immediate dilution of their investment upon closing. An evaluation of fair value of the existing securities before and after the modification...
may indicate that a transfer of value from the existing preferred stockholders to the new preferred shareholders and the common stockholders has occurred. However, these transactions are often very complex and should be carefully considered to determine the appropriate accounting. Not all of them necessarily constitute transfers of value between the preferred and common shareholder classes, and therefore they may not require recognition as a deemed dividend. For example, while the fair value of the existing preferred stock may be impacted by the changed terms, the value of the entire business may also be impacted by the raising of new capital. In these capital restructurings, it may be reasonable to conclude that the increase in common stock value is incidental to the capital being raised and is not due to a deemed dividend received from the existing preferred shareholders.

### 7.9 Conversion of convertible preferred stock

In a conversion of convertible preferred stock pursuant to original conversion terms, the preferred stock is exchanged for common shares with no effect on retained earnings. However, the exchange of a number of common shares for preferred stock that differs from the number of common shares exchangeable under the original conversion terms (other than an induced conversion) is considered an extinguishment.

When a conversion right is exercised, a period of time may elapse between the irrevocable election to convert and the legal exchange of shares. A reporting entity should reflect the conversion in its financial statements only once the legal rights of the investors have changed pursuant to the conversion, and reflect those of common shareholders rather than preferred stockholders.

#### 7.9.1 Induced conversions

An induced conversion is a transaction in which a reporting entity offers additional shares or other consideration (“sweeteners”) to investors to incentivize them to convert their convertible instrument. For example, a reporting entity may reduce the original conversion price or issue additional consideration (e.g., cash or warrants) not provided for in the original conversion terms to holders that agree to convert during a limited offer period. See FG 6.9.1.2 for additional information on induced conversions.

ASC 260-10-S99-2 addresses the accounting for induced conversions of preferred stock.

**Excerpt from ASC 260-10-S99-2**

If convertible preferred stock is converted into other securities issued by the registrant pursuant to an inducement offer, the SEC staff believes that the excess of (1) the fair value of all securities and other consideration transferred in the transaction by the registrant to the holders of the convertible preferred stock over (2) the fair value of securities issuable pursuant to the original conversion terms should be subtracted from net income to arrive at income available to common stockholders in the calculation of earnings per share. Registrants should consider the guidance provided in Subtopic 470-20 to determine whether the conversion of preferred stock is pursuant to an inducement offer.

In an induced conversion of preferred stock, the fair value of the inducement is charged to retained earnings with an offsetting credit to the inducement consideration as appropriate (e.g., cash, common stock). The fair value of the inducement is also reflected in earnings per share.
The conversion of an instrument into common or preferred stock is not an extinguishment if it only represents the exercise of a conversion right that was included in the original terms of the instrument.

7.9.2 Conversion of an instrument with a BCF

ASC 470-20-40-1 requires a reporting entity to recognize any unamortized discount resulting from the separation of a BCF upon conversion of the instrument. For convertible preferred stock, the charge should be recognized as a dividend in retained earnings and earnings per share. Any other unamortized discounts (e.g., created by allocating proceeds to warrants issued with the convertible instrument) should also be recognized as interest expense or as a dividend to retained earnings upon conversion. In accordance with ASC 470-20-40-2, if the amount of BCF discount amortized exceeds the amount the holder realized because conversion occurred at an earlier date, no adjustment should be made to amounts previously amortized. This guidance is unique to convertible instruments containing a BCF and should not be applied to other convertible instruments.

If a convertible instrument with a multiple-step discount is converted at a point in time when the conversion price on that date is less beneficial than the conversion price used to initially record the BCF, any previously recognized amortization of the discount created by separating the BCF should not be reversed. See FG 7.3.2.2 for information on BCFs with a multiple-step discount.

7.10 Preferred stock extinguishment

When preferred stock is extinguished, the issuer should include the gain or loss on extinguishment in its net income attributable to common shareholders used to calculate earnings per share, as described in ASC 260-10-S99-2.

Excerpt from ASC 260-10-S99-2

If a registrant redeems its preferred stock, the SEC staff believes that the difference between (1) the fair value of the consideration transferred to the holders of the preferred stock and (2) the carrying amount of the preferred stock in the registrant’s balance sheet (net of issuance costs) should be subtracted from (or added to) net income to arrive at income available to common stockholders in the calculation of earnings per share. The SEC staff believes that the difference between the fair value of the consideration transferred to the holders of the preferred stock and the carrying amount of the preferred stock in the registrant’s balance sheet represents a return to (from) the preferred stockholder that should be treated in a manner similar to the treatment of dividends paid on preferred stock.

Although there is no guidance specifically on point, we believe direct costs associated with a preferred stock extinguishment (e.g., attorney fees) should be included when calculating the amount of consideration transferred.

If the fair value of the consideration transferred is greater than the carrying amount of the shares surrendered, (1) retained earnings should be reduced by the difference (or additional paid-in capital in the absence of retained earnings), and (2) earnings available to common shareholders should be reduced by the difference.
If the fair value of the consideration transferred is less than the carrying amount of the shares surrendered, the difference should be credited to retained earnings and added to earnings available to common shareholders.

The accounting for an extinguishment of preferred stock classified as a liability under the guidance in ASC 480 is the same as that for other debt instruments. See FG 3.7 for information on accounting for debt extinguishments.

### 7.10.1 Redemption of convertible preferred stock with a BCF

As discussed in ASC 260-10-S99-2, when a reporting entity redeems convertible preferred stock, it should allocate a portion of the redemption consideration to the reacquisition of the BCF; the remainder of the consideration is allocated to the redemption of the preferred stock. The amount of consideration allocated to reacquisition of the BCF should be equal to the intrinsic value previously recognized (i.e., the original intrinsic value). When the EITF reached this conclusion in its deliberation of EITF Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments, it acknowledged that this treatment is inconsistent with the approach applied to the redemption of convertible debt with a BCF. In that circumstance, the redemption consideration is allocated to the BCF based on its extinguishment date intrinsic value.

Example 7-5 illustrates how to account for the redemption of preferred stock with a BCF.

**EXAMPLE 7-5**

Redemption of preferred stock with a BCF

FG Corp issues $1,000 of convertible perpetual preferred stock and 100 detachable warrants to purchase its common stock in exchange for $1,000 cash. The convertible preferred stock is convertible into 100 shares ($1,000 convertible preferred stock / 100 shares = $10 conversion price) immediately upon issuance. The warrants have a strike price of $10 per share.

FG Corp’s stock price on the date the instrument is issued, which is the commitment date, is $10 per share. The fair value of the warrants on that date is $300.

FG Corp concludes that the warrants should be classified as a liability. Since the warrants are classified as a liability, FG Corp first allocates the proceeds to the warrant based on its fair value ($300); the remaining proceeds ($700) are allocated to the convertible preferred stock.

One year after issuance, FG Corp redeems the convertible preferred stock for $1,200. The convertible preferred stock’s carrying amount is $700 and the BCF recorded is $300.

How should FG Corp account for the redemption of its convertible preferred stock?
Analysis

The redemption of the convertible preferred stock based on allocated reacquisition proceeds of $900 ($1,200 cash paid - $300 original intrinsic value of the conversion feature) would be recorded with the following entry:

Dr. Convertible preferred stock $700
Dr. Retained earnings (loss) $200
Cr. Cash $900

FG Corp would then record the redemption of the BCF at its original intrinsic value of $300.

Dr. Additional paid-in capital (BCF) $300
Cr. Cash $300

The $200 charged to retained earnings upon redemption is in addition to the $300 charged to retained earnings when the BCF was recognized.

Extinguishment of a subsidiary’s preferred stock

The accounting for the redemption of a subsidiary’s preferred stock depends on its balance sheet classification, as discussed in ASC 810-10-40-2 and ASC 810-10-40-2A.

Excerpt from ASC 810-10-40-2

[If] 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.

Excerpt from ASC 810-10-40-2A

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.
8.1 Chapter overview

In this chapter we discuss contracts under which a reporting entity sells its own shares for future delivery. These contracts include forward sale contracts, warrants, and variable share forward delivery agreements (components of a mandatory unit structure). This chapter also includes a discussion of the model for allocating proceeds and issuance costs to freestanding instruments issued together, such as debt with detachable warrants. Lastly, this chapter discusses certain instruments issued to shareholders.

See FG 9 for information on contracts to repurchase a reporting entity’s own shares.

8.2 Contracts to issue shares

For various reasons a reporting entity may choose to sells its own shares for future delivery using a derivative instrument; these contracts can either require the reporting entity to issue shares or give the investor the option to buy shares. Figure 8-1 summarizes these contracts.

**Figure 8-1**
Summary of contracts to issue shares

<table>
<thead>
<tr>
<th>Contract</th>
<th>Summary of terms</th>
<th>Mandatory or optional settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward sale</td>
<td>Reporting entity agrees to sell a fixed number of shares to an investor on a specified date in the future, typically at a fixed price</td>
<td>Mandatory</td>
</tr>
<tr>
<td>Warrant (written call option)</td>
<td>The investor can buy a fixed number of shares on or by a specified date in the future or upon the occurrence of an event, typically at a fixed price</td>
<td>Investor’s option</td>
</tr>
<tr>
<td>Variable share forward delivery agreement</td>
<td>The reporting entity agrees to sell a variable number of shares, based on its stock price or some other variable, to an investor at a fixed price on a specified date in the future</td>
<td>Mandatory</td>
</tr>
</tbody>
</table>

A fixed price contract typically allows for a price adjustment upon the occurrence of specified events.

Settlement may involve “gross physical settlement” where the full number of shares underlying the contract and exercise prices are exchanged or “net settlement” where the unrealized economic gain or loss on the contract is settled by the payment of cash or shares.

8.2.1 Forward sale contracts

A forward sale contract obligates the holder to buy (and obligates the reporting entity to sell) a specified number of the reporting entity’s shares at a specified date and price. A forward contract effectively fixes the price a holder will pay for the reporting entity’s stock.
Most forward sale contracts are not within the scope of ASC 480, *Distinguishing Liabilities from Equity*; however, the terms of each contract should be evaluated to determine whether that is the case. Certain forward sale contracts are within the scope of ASC 480, including:

- A prepaid forward contract to deliver a variable number of the reporting entity’s own shares for a fixed monetary amount
- A forward contract to sell redeemable shares

See FG 5.5 for further information on ASC 480.

If a reporting entity concludes that a forward contract is not within the scope of ASC 480, the next step is to determine whether the contract should be classified as a liability or equity under the guidance in ASC 815-40, *Derivatives and Hedging—Contracts in Entity’s Own Equity*. See FG 5.6 for further information on the analysis of a freestanding equity-linked instrument.

### 8.2.1.1 Forward sale contracts on redeemable equity

A reporting entity may enter into a forward sale contract on any class of equity instrument, including preferred shares that are redeemable or contingently redeemable for cash or other assets upon the occurrence of events outside the control of the reporting entity.

A forward sale contract on redeemable shares should be classified as a liability (or, in some cases, an asset, depending on the contract’s stock price) based on the guidance in ASC 480 because it creates an obligation for the reporting entity to repurchase its shares. As discussed in ASC 480-10-55-33, this guidance not only applies to mandatorily redeemable and puttable shares, but also to shares that are redeemable, or contingently redeemable, upon a defined contingency; the probability of the contingency occurring should not be considered.

See FG 5.5 for further information on ASC 480.

### 8.2.2 Warrants (written call options)

A warrant (or written call option) on a reporting entity’s own stock gives the holder the right, but not the obligation, to buy the reporting entity’s shares on or by a certain date, at a specified price. The reporting entity receives a premium from the holder when it issues a warrant on its own stock, although oftentimes the premium may be in the form of a lower interest rate on a debt instrument or some other noncash consideration. See FG 8.3.1 for information on accounting for warrants issued with another instrument.

A warrant to sell common or preferred equity is generally outside the scope of ASC 480; however, some warrants, including puttable warrants and warrants on redeemable shares, are within the scope of ASC 480. See FG 8.2.2.1 for information on puttable warrants and FG 8.2.2.2 for information on warrants on redeemable shares.

If a reporting entity concludes that a warrant is not within the scope of ASC 480, the next step is to determine whether the contract should be classified as a liability or equity under the guidance in ASC 815-40. See FG 5.6 for further information on the analysis of a freestanding equity-linked instrument.
8.2.2.1 Puttable warrants

A puttable warrant is an instrument that allows the holder to either (1) exercise the warrant and receive shares or (2) put the warrant to the reporting entity in exchange for a cash payment. The put feature may be conditional or unconditional.

As discussed in ASC 480-10-55-30, a puttable warrant creates a conditional obligation for the reporting entity to repurchase its shares for cash (or other assets); therefore, it is a liability within the scope of ASC 480. Share-settled put warrants that create an obligation for the reporting entity to issue a variable number of shares may also be within the scope of ASC 480.

ASC 480-10-55-30

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.

Even if the put right can be only be exercised upon the occurrence of certain events, a puttable warrant should be classified as a liability within the scope of ASC 480. See FG 5.5 for further information on ASC 480.

8.2.2.2 Warrants on redeemable shares

As discussed in ASC 480-10-55-33, a warrant on redeemable shares (i.e., puttable or mandatorily redeemable shares) is a liability within the scope of ASC 480 because it creates a conditional obligation for the reporting entity to repurchase its shares for cash (or other assets).

ASC 480-10-55-33

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 classification of the underlying shares issued upon exercise should not be considered to determine the classification of the warrants. The fact that the shares are puttable (which allows the holder to compel the reporting entity to redeem the shares) is the key fact in determining the warrant’s classification.
See FG 5.5 for further information on ASC 480.

### 8.2.2.3 Penny warrants

A penny warrant is an instrument that requires the holder to pay little or no consideration to receive the shares upon exercise of the warrant. Since the shares underlying the warrant are issuable for little or no consideration, they should be considered outstanding in the context of earnings per share, as discussed in ASC 260-10-45-13. See FSP 7 for information on including penny warrants in earnings per share.

Penny warrants often do not meet the definition of a derivative under ASC 815 because their fair value at issuance is equal to the fair value of the shares underlying the warrant. As such, they have the characteristics of a prepaid forward sale of equity. It is generally appropriate to account for them as equity instruments.

### 8.2.2.4 Warrants to participate in a future equity offering

A reporting entity may issue a warrant that allows the holder to purchase shares of the reporting entity’s next issuance of preferred stock at the same price paid by other investors in that preferred stock. A warrant to participate in a future equity offering is typically issued to a debt or equity investor. The terms of the future issuance of preferred stock are generally unknown and subject to negotiation with potential investors. Absent a future preferred stock issuance, the warrant holder is not entitled to exercise the warrant for any other consideration.

At issuance, these warrants are not a liability within the scope of ASC 480 because they are within the reporting entity’s control to decide whether it will sell preferred stock or not. Further, since the terms of any future preferred stock issuance have not been determined, and when determined will generally be based upon market terms, reporting entities generally do not recognize these contracts until the terms are negotiated and the preferred shares are issued.

See FG 7.6 for information on tranches of preferred stock.

### 8.2.2.5 Beneficial conversion features in warrants to acquire convertible shares

A beneficial conversion feature (BCF) is an embedded conversion option that is in the money at the commitment date. FG 7.3.2.2 provides a detailed discussion on BCFs; this section only discusses the accounting for BCFs in warrants to acquire convertible shares. See FG 7.3.2.2 for further information on the accounting for BCFs.

Whether a BCF in a warrant to acquire convertible shares should be recognized when the warrant is issued or when the warrant is exercised (and the convertible shares are issued), depends on the classification of the warrant itself.

The Emerging Issues Task Force considered whether a warrant to acquire convertible shares may have a BCF during its deliberations of EITF No. 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments. Although this guidance has not been finalized, we believe the EITF’s tentative conclusions may be applied in the absence of other guidance. The EITF tentatively concluded that, for warrants classified as a liability, a reporting entity should not assess whether there is a BCF until the warrant is exercised and the convertible shares are issued, provided the warrant can only be physically settled in shares. To determine the intrinsic value upon exercise, the EITF concluded that a reporting
entity should compare the fair value of the reporting entity’s common stock (or other shares into which the security is convertible) on the exercise date with the effective conversion price. The effective conversion price should be calculated as the sum of the carrying amount of the warrant liability plus the exercise price of the warrant divided by the number of common shares the warrant holder receives if the conversion feature embedded in the convertible share is exercised.

Example 8-1 illustrates the application of this guidance to the recognition of a BCF in warrants to purchase convertible preferred stock.

**EXAMPLE 8-1**

**Recognition of a BCF in warrants**

FG Corp issues 100 warrants that allow each holder to buy convertible preferred shares. The exercise price is $10 per warrant. Each convertible preferred share is convertible into 5 shares of FG Corp common stock, or 500 shares in total.

FG Corp determines that the warrants should be classified as a liability with a fair value of $1,000.

Two years after the warrants are issued, the warrant holder exercises the warrants and receives 100 shares of FG Corp convertible preferred stock. On that date, the fair value of FG Corp common stock is $25 and the carrying value (fair value) of the warrants is $13,000.

When and how should FG Corp determine whether there is a BCF in the warrants that holders can exercise to buy its convertible preferred stock?

*Analysis*

Since the warrants are classified as a liability, FG Corp assesses whether there is a BCF to be recognized when the warrant is exercised, not when the warrant is issued.

Upon exercise of the warrants, FG Corp compares (1) the fair value of the common shares on the exercise date ($25) with (2) the effective conversion price of $28 and determines there is no BCF. The effective conversion price is calculated as follows:

\[ \frac{\text{($13,000 carrying amount of the warrant liability plus $1,000 exercise price of the warrant)}}{500 \text{ shares (the number of common shares received upon conversion of the convertible shares)}} \]

The effective conversion price on the date warrants are exercised is typically greater than the fair value of the common shares. Therefore, there is generally no BCF.

The EITF tentatively reached a different conclusion for warrants classified as equity that will be physically settled in shares. For those warrants, the EITF concluded that a reporting entity should assess whether there is a BCF on the date warrants are issued. This conclusion assumes the reporting entity receives fair value for the warrants (or for the warrants and any other instruments issued at the same time) upon issuance. If the reporting entity receives less than the fair value of the warrants, it should assess whether there is a BCF when the warrants are exercised and the convertible shares are received, similar to liability-classified warrants.
To determine the intrinsic value of an equity-classified warrant, the EITF concluded that a reporting entity should compare the fair value of the reporting entity’s common stock (or other shares into which the security is convertible) on the date the warrant is issued with the effective conversion price. The effective conversion price should be calculated as the sum of the proceeds received for (or amount allocated to) the warrant plus the exercise price of the warrant divided by the number of common shares the warrant holder receives if the conversion feature embedded in the convertible share is exercised.

If a reporting entity determines that a BCF should be recognized, it should be recorded as a deemed distribution to the warrant holder. The amount of the BCF cannot exceed the proceeds allocated to the warrant, and should be amortized over the life of the warrants. Upon exercise of the warrants, the unamortized BCF amount should be amortized from the exercise date of the warrant through the stated maturity date of the underlying convertible instrument. If the underlying convertible instrument does not have a stated maturity date, the remaining BCF should be amortized from the exercise date through the date the shares are first convertible.

8.3 Accounting for freestanding instruments issued together

A reporting entity may issue multiple freestanding instruments in a bundled transaction. Typically, a debt or preferred equity instrument is issued with a share issuance contract, such as a warrant or variable share delivery agreement. A reporting entity may issue freestanding instruments together to meet its financing objectives, meet its investors’ objectives, or for tax purposes.

If a reporting entity issues a non-detachable equity derivative, such as a warrant, with a debt or preferred stock instrument (i.e., the debt or equity security must be surrendered or repaid in order to exercise the warrant), the combined instrument is substantially equivalent to convertible debt or convertible preferred stock. In that case, the reporting entity should account for the combined instrument using the guidance for convertible debt or convertible preferred stock. See FG 5 for information on accounting for convertible debt FG 7 for information on the accounting for convertible preferred stock.

When multiple investors invest in multiple classes of instruments (e.g., preferred stock, common stock, and warrant) in different quantities, the allocation of proceeds to each instrument should be performed at the investor level, not the class level. See FG 3.1 for information on allocating proceeds to each instrument.

8.3.1 Warrants issued in connection with debt or equity

Detachable warrants issued in a bundled transaction with debt and equity offerings are accounted for separately. The allocation of the sales proceeds between the base instrument (i.e., the debt or equity instrument) and the warrants depends on the whether the warrants should be accounted for as equity or a liability. See FG 5.2 for information on the analysis of equity-linked instruments.

If the warrants are classified as equity, then the proceeds should be allocated based on the relative fair values of the base instrument and the warrants following the guidance in ASC 470, Debt.
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 [Interest].

Although this guidance is for debt instruments issued with warrants, preferred shares issued with warrants should be accounted for in a similar manner.

If the warrants are classified as a liability and recorded at fair value with changes in fair value recorded in the income statement, then the proceeds should be allocated first to the warrants based on their fair value (not relative fair value). The residual should be allocated to the base debt or equity instrument. This approach avoids the possibility of recording a day one gain or loss on the warrant which could arise if the allocation were made on a relative fair value basis.

The allocation of proceeds to the warrant, using either method, will typically create a discount in the associated debt or equity instrument, which should be recognized as interest expense or a dividend.

Example 8-2 illustrates the model for allocating proceeds when equity classified warrants are issued in connection with a debt instrument. Example 8-3 illustrates the model for allocating proceeds when liability classified warrants are issued in connection with a debt instrument.

**EXAMPLE 8-2**

Warrants classified as equity issued in connection with a debt instrument

FG Corp issues $1,000 of debt and 100 detachable warrants to purchase its common stock, in exchange for $1,000 in cash. FG Corp concludes that the warrants meet the requirements for equity classification.

Since the warrants are classified as equity, FG Corp allocates the proceeds from the issuance of the debt instrument and warrants based on their relative fair values.

The fair values and amounts allocated to the debt instrument and warrants are shown in the table below.

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Fair value</th>
<th>Percent of total fair</th>
<th>Allocated amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$910</td>
<td>70%</td>
<td>$700</td>
</tr>
<tr>
<td>Warrants</td>
<td>$390</td>
<td>30%</td>
<td>$300</td>
</tr>
<tr>
<td>Total</td>
<td>$1,300</td>
<td>100%</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

How should FG Corp record the issuance of the debt instrument and warrants?
Analysis

FG Corp should record the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Cash</td>
<td>Cr. Debt instrument</td>
</tr>
<tr>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Dr. Discount on debt instrument</td>
<td>Cr. Additional paid-in capital—warrants</td>
</tr>
<tr>
<td>$300</td>
<td>$300</td>
</tr>
</tbody>
</table>

**EXAMPLE 8-3**

Warrants classified as liabilities issued in connection with a debt instrument

FG Corp issues $1,000 of debt and 100 detachable warrants to purchase its common stock, in exchange for $1,000 in cash. FG Corp concludes that the warrants have a fair value of $390 and meet the requirements for liability classification.

How should FG Corp record the issuance of the debt instrument and warrants?

**Analysis**

Since the warrants are classified as a liability, FG Corp allocates the proceeds from the issuance of the debt instrument first to the warrants based on their fair value. The residual amount is allocated to the debt instrument.

FG Corp should record the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Cash</td>
<td>Cr. Warrant liability</td>
</tr>
<tr>
<td>$1,000</td>
<td>$390</td>
</tr>
<tr>
<td>Dr. Discount on debt instrument</td>
<td>Cr. Debt instrument</td>
</tr>
<tr>
<td>$390</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

### 8.3.1 Allocation of issuance costs to non-revolving debt issued with warrants

Issuance costs associated with a debt instrument and warrants issued in a bundled transaction should be allocated to each instrument using a reasonable method.

The allocation of issuance costs should mirror the accounting for the warrant itself. Issuance costs should be allocated in the same proportion as the proceeds are allocated to the debt and warrants. Issuance costs allocated to a warrant liability should be expensed as incurred and issuance costs allocated to an equity-classified warrant should be recorded in equity.

Issuance costs that relate specifically to the issuance of the debt or the warrant, rather than the transaction as a whole, should be allocated to that instrument.
This discussion does not apply to convertible debt within the cash conversion sections of ASC 470-20. These subsections apply to convertible debt instruments that allow, or require, the reporting entity to settle its obligation upon conversion, in whole or in part, in a combination of cash and stock. See FG 6.6 for information on ASC 470-20.

See FG 1.2.2 for further information on which costs qualify as issuance costs.

8.3.1.2 Line of credit issued with detachable warrants

The guidance in ASC 470-20-25-2 does not apply when warrants are issued to obtain a line of credit rather than in connection with the issuance of a debt instrument. Warrants issued to obtain a line of credit should be recorded at fair value when the line of credit agreement is signed; this is the accounting regardless of whether the warrants are classified as a liability or equity. Issuing warrants to obtain a line of credit is equivalent to paying a loan commitment or access fee; therefore, the offsetting entry should be recorded to debt issuance costs and amortized on a straight-line basis over the stated term of the line of credit. This accounting applies even if the line is fully drawn down at inception, since the warrants are issued in exchange for access to capital.

See FG 5.2 for information on the analysis of equity-linked instruments including warrants.

8.3.1.3 Repurchase of debt with detachable warrants

When a reporting entity extinguishes debt with detachable warrants that are classified as equity, it should allocate the repurchase price to the debt instrument and the warrants using a relative fair value allocation.

The repurchase price amount allocated to the debt instrument should be used to calculate any gain or loss on debt extinguishment. See FG 3.7 for information on debt extinguishment accounting.

The repurchase price amount allocated to the warrants is recorded as a reduction of additional paid-in capital. There is no gain or loss recognized in the income statement when a common equity instrument is retired provided the reporting entity does not convey additional rights and privileges.

8.3.2 Mandatory units

Mandatory units are equity-linked financial products often marketed under different proprietary names by different financial institutions (e.g., ACES, PRIDES, or DECS). Typically, from the reporting entity’s perspective, a mandatory unit consists of (a) a term debt instrument with a remarketing feature and (b) a “variable share forward delivery agreement,” i.e., a detachable forward sale contract that obligates the investor to purchase shares of the reporting entity’s common stock at a specified time and at a specified price before the maturity of the debt instrument. The number of shares to be received by the holder is based on the market price of the reporting entity’s stock on the settlement date of the contract.

Typically, the terms of the debt instrument issued as part of a mandatory unit structure include:

- A stated principal amount equal to the settlement price of the variable share forward delivery agreement. The debt instrument is pledged to secure the investor’s obligation to pay the settlement price of the variable share forward delivery agreement.
A fixed maturity with a “remarketing” that occurs close to the maturity date of the variable share forward delivery agreement.

The interest rate is a fixed rate for the period from issuance to the remarketing date.

At the remarketing date, the debt instrument is sold to new investors at par with a new interest rate equal to the then market rate for debt with a remaining term to maturity. The debt instrument must be sold for an amount at least equal to par, which is the settlement price of the variable share forward delivery agreement. If the remarketing does not result in a successful sale at the minimum required price (i.e., a failed remarketing), then the debt instrument is delivered to the reporting entity to pay the settlement price of the variable share forward delivery agreement. Generally, the interest rate a reporting entity will pay upon remarketing is not limited, making a failed remarketing less likely to occur.

The number of shares issued under the variable share forward delivery agreement will depend on the price of the underlying stock at the end of the contract. For example, an agreement may be structured as follows, assuming an investor pays $50 to settle the variable share forward delivery agreement:

<table>
<thead>
<tr>
<th>If the stock price is:</th>
<th>The reporting entity issues:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $50</td>
<td>1 share</td>
</tr>
<tr>
<td>Between $50 and $62.50</td>
<td>A pro rata portion of a share, between 1 and 0.8 shares, equal to $50</td>
</tr>
<tr>
<td>Greater than $62.50</td>
<td>0.8 shares</td>
</tr>
</tbody>
</table>

In this example, the variable share forward delivery agreement comprises three features from the issuer’s perspective:

- A purchased put on the issuer’s own shares (a put on one share with an exercise price of $50)
- A written call option on the issuer’s own shares (a call on 0.8 shares with an exercise price of $62.50)
- An agreement to issue the issuer’s own shares at their prevailing fair values (if the share price is between $50 and $62.50)

Because the variable share forward delivery agreement is legally detachable from the debt instrument, it is typically considered a freestanding instrument and accounted for separately. See FG 5.3 for further information on determining whether an instrument is freestanding or embedded.

ASC 480-10-55-50 provides guidance for analyzing a variable share forward delivery contract.
ASC 480-10-55-50

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.

If a reporting entity concludes that a variable share forward delivery agreement is not within the scope of ASC 480, the next step to determine the accounting treatment is to determine whether it should be classified as a liability or equity under the guidance in ASC 815-40. See FG 5.6 for further information on the analysis of a freestanding equity-linked instrument.

8.3.2.1 Contract payments paid by the reporting entity

Typically, the investor in a mandatory unit structure receives quarterly payments comprising both (a) interest on the debt instrument and (b) “contract payments” on the variable share forward delivery agreement. The contract payments result from the fact that the purchased put in the variable share forward delivery agreement has a greater value than the written call, resulting in a net premium which must be paid for the net purchased put on the reporting entity’s own stock. Rather than paying the premium up front, the issuer pays the premium over time in the form of contract payments.

If the variable share forward delivery agreement is accounted for as an equity instrument, the reporting entity should account for the obligation to make the contract payments as a liability measured at the present value of the payments over the life with an offsetting entry to additional paid-in capital. The liability is subsequently accreted using the effective interest method over the life of the variable share forward delivery agreement, with an offsetting entry to interest expense.

8.3.2.2 Application example

Example 8-4 illustrates the accounting for mandatory units.

EXAMPLE 8-4

Accounting for mandatory units

FG Corp issues 10 mandatory units to investors. Each mandatory unit has a stated par value of $1,000 and consists of:

- A five-year debt security of FG Corp with an initial rate of 4%, paid quarterly, for the first thirty-three months. At the end of 33 months, the debt security will be remarketed and the interest rate will reset to the market rate for the remaining life of the debt security.

- A three-year variable share forward delivery agreement with a 1% contract payment. At maturity, each investor will pay FG Corp $1,000 per unit and get a variable number of shares depending on FG Corp’s stock price at the maturity date, as summarized below.
If the stock price is: | FG Corp issues:
---|---
Less than $50 | 20 shares
Between $50 and $62.50 | A pro rata number of shares equal to $1,000
Greater than $62.50 | 16 shares

FG Corp’s common stock has a $1.00 par value.

FG Corp determines that the debt security and the variable share forward delivery agreement should be accounted for separately because they are legally detachable and separately exercisable. In addition, FG Corp performs an analysis of the variable share forward delivery agreement and concludes that it is indexed to its own stock and meets the additional requirements for equity classification in ASC 815-40 and, therefore, should be accounted for as an equity instrument. As a result, the proceeds are allocated to the debt security and the variable share forward delivery contract based on their relative fair values. The variable share forward delivery agreement has a fair value of $275; the fair value is imputed based upon the present value of the contract payments discounted at FG Corp’s three year financing rate.

Upon remarketing, the interest rate on the debt resets to FG’s then current borrowing rate of 3.8%. At settlement of the variable share forward delivery agreement, FG Corp’s stock price is $65.00.

How should FG Corp record (1) the issuance of the mandatory units, (2) the periodic entries over the life of the instrument, (3) the remarketing of the debt security, (4) the maturity of the variable share forward delivery agreement, and (5) the maturity of the debt?

**Analysis**

**Issuance of the mandatory units**

FG Corp records the issuance of its mandatory units by recording the cash proceeds, the debt security, and the present value of the contract payments related to the variable share forward delivery agreement.

- Dr. Cash $10,000
- Dr. Equity – APIC $275
- Cr. Debt security $10,000
- Cr. Contract payment liability $275

**Periodic entries over the life of the instrument**

FG Corp calculates the quarterly interest expense as follows:

\[
10,000 \times 4\% \times \frac{1}{4} = 100
\]
FG Corp records interest payments made to investors.

\[
\begin{align*}
\text{Dr. Interest expense} & \quad $100 \\
\text{Cr. Cash} & \quad $100
\end{align*}
\]

FG Corp calculates the quarterly contract payment as follows:

\[
$10,000 \times 1\% \times \frac{1}{4} = $25
\]

FG Corp records the cash paid for the contract payment obligation; the offsetting entry is recorded to reduce the contract payment liability and recognize interest expense on the contract payment liability.

\[
\begin{align*}
\text{Dr. Contract payment liability} & \quad $23 \\
\text{Dr. Interest expense} & \quad $2 \\
\text{Cr. Cash} & \quad $25
\end{align*}
\]

**Upon remarketing of the debt security**

Once the debt security is remarshaled, FG Corp records quarterly interest expense of $95 ($10,000 \times 3.8\% \times \frac{1}{4} = $95) over the remaining life.

\[
\begin{align*}
\text{Dr. Interest expense} & \quad $95 \\
\text{Cr. Cash} & \quad $95
\end{align*}
\]

The actual remarketing is not recognized by FG Corp as an extinguishment and reissuance because it is a transaction among third party market participants.

**Upon maturity of the variable share forward delivery agreement**

FG Corp records the proceeds received upon settlement of the variable share forward delivery agreement and the issuance of shares at par value (10 units \times 16 shares per unit \times $1.00 par value = $160) with the remainder recorded to APIC.

\[
\begin{align*}
\text{Dr. Cash} & \quad $10,000 \\
\text{Cr. Equity – par value common stock} & \quad $160 \\
\text{Cr. Equity – APIC} & \quad $9,840
\end{align*}
\]

**Upon maturity of the debt security**

FG Corp records the cash paid upon redemption of the debt security.

\[
\begin{align*}
\text{Dr. Debt} & \quad $10,000 \\
\text{Cr. Cash} & \quad $10,000
\end{align*}
\]
8.3.2.3 Issuance costs

Issuance costs associated with mandatory units should be allocated between the components in a rational manner.

The variable share delivery agreement is typically accounted for as an equity instrument; therefore, the issuance costs should be allocated to the debt instrument and the variable share delivery agreement based on their relative fair values following the guidance in ASC 470-20-25-2.

See FG 1.2.2 for further information on which costs qualify as issuance costs.

8.3.2.4 Earnings per share

The diluted earnings per share (EPS) treatment of a unit structure depends on whether (1) the debt instrument can be tendered to satisfy the investor’s payment of the exercise price for the variable share forward delivery agreement and (2) whether the debt instrument and variable share forward delivery agreement mature on, or close to, the same date.

ASC 260-10-55-9 specifies that instruments that require or permit the tendering of a debt instrument in satisfaction of the exercise price should be included in diluted EPS by assuming (1) the share issuance is exercised and (2) the debt instrument is tendered (interest, net of tax, is added to the numerator of the diluted EPS calculation). This method results in EPS dilution similar to the use of the if-converted method. See FSP 7.5.6 for information on the if-converted method. This same treatment should be applied if the debt instrument and variable share forward delivery agreement mature on, or close to, the same date.

If the debt instrument cannot be tendered to satisfy the investor’s payment of the exercise price for the share issuance derivative, the instrument is included in diluted EPS as follows:

- The coupon on the debt instrument is included as interest expense and therefore results in a reduction of earnings available to common shareholders
- The variable share forward delivery agreement is included as a potentially issuable common share using the treasury stock method; see FSP 7.5.5 for information on applying the treasury stock method

Typically, the base security in the unit offering will be remarketed at some point prior, but close to, the maturity of the variable share forward delivery agreement. For example, the debt instrument may have a five year life, with a remarketing after 2.75 years, and the variable share forward delivery agreement will mature at the end of 3 years. With at least 90 days difference between the debt instrument’s remarketing date and the maturity of the variable share forward delivery agreement, the two instruments are not considered coterminus so the treasury stock method should be applied. However, most securities also allow the investor to use the debt instrument to satisfy the exercise price of the share issuance derivative in the event of a failed remarketing. If this occurs, the two instruments do co-terminate and the approach similar to the if-converted method should be applied.

In determining the method for including a unit structure in diluted EPS, a reporting entity should consider the likelihood that the debt instrument will be used to satisfy the exercise price of the variable share forward delivery agreement (i.e., they will co-terminate). If the instruments are coterminus only
upon a failed remarketing, then provided the likelihood of a failed remarketing is considered remote, use of the treasury stock method is generally appropriate.

8.3.2.5 Repurchase of mandatory units

When a reporting entity extinguishes mandatory units, such as through an open market repurchase of the securities, the accounting treatment depends on whether the variable share forward delivery agreement is economically an asset or liability to the issuer. For example, using the terms in Example 8-4:

- If the issuer’s stock price were $40, it would be required to deliver 20 shares of its stock with a fair value of $800 in exchange for $1,000 in cash; therefore the variable share forward delivery agreement is economically in a gain position to the issuer.
- If the issuer’s stock price were $75, it would be required to deliver 16 shares of its stock with a fair value of $1,200 in exchange for $1,000 in cash, therefore the variable share forward delivery agreement is economically in a loss position to the issuer.

The contract payment liability discussed in FG 8.3.2.1 is an additional liability that should be included in the debt extinguishment analysis discussed below.

If the variable share forward delivery agreement is economically a liability to the issuer, the repurchase price (cash and fair value of the common stock) should be allocated to the debt instruments (i.e., the debt instrument and contract payment liability) and variable share forward delivery agreement using a relative fair value methodology.

- A gain or loss on extinguishment equal to the difference between (1) the amount allocated to the debt instruments and (2) the carrying value is recognized in earnings; see FG 3.7 for further discussion of debt extinguishment accounting

- The portion of the repurchase price attributable to the variable share forward delivery agreement is recorded as a reduction of additional paid-in capital. There is no loss recognized when a common equity instrument is retired provided the issuer does not convey additional rights and privileges that require recognition of income or expense

If, however, the variable share forward delivery agreement is economically an asset to the issuer, we believe the fact that the forward is being used as consideration to extinguish the obligation should be considered. One method of doing this is to record:

- A gain or loss on extinguishment equal to the difference between (1) the consideration paid plus the fair value of the variable share forward delivery agreement and (2) the carrying value of the debt instrument; see FG 3.7 for further discussion of debt extinguishment accounting

- The portion of the repurchase price attributable to the variable share forward delivery agreement (i.e., its fair value used in calculating the gain or loss on extinguishment) is recorded as an increase in additional paid-in capital

There may be other acceptable methods of performing this calculation.
8.4 Shareholder rights plan ("poison pill" takeover defenses)

To discourage unfriendly takeover attempts, a reporting entity may grant its existing shareholders rights which convert to the reporting entity’s common stock upon the occurrence of specified events, such as the accumulation of a significant percentage of the reporting entity’s outstanding shares by a single shareholder. These rights are often referred to as “poison pill” takeover defenses. The issuance of rights to existing shareholders is typically accounted for as a dividend with the offsetting entry recorded to APIC, if the rights meet the requirements for equity classification, or as a liability, if they do not meet the requirements for equity classification. See FG 5.2 for information on the analysis of equity-linked instruments.
Chapter 9: Share repurchase and treasury stock
9.1 Chapter overview

When a reporting entity repurchases its shares, it is distributing cash to existing shareholders to reacquire a portion of its outstanding equity. Once a reporting entity has acquired its own shares it may choose to retire the reacquired shares or hold them as treasury stock.

This chapter discusses the accounting for several share repurchase alternatives. It also discusses the accounting for treasury stock and share retirements.

9.2 Share repurchases

A reporting entity may repurchase its shares for a number of reasons, including to:

- Return cash to shareholders
- Increase earnings per share or other financial metrics (e.g., return on equity) that may be of interest to shareholders
- Send a signal to the market that management believes its common stock price is undervalued
- Offset the issuance of shares (e.g., from employee stock option exercise)
- Preclude potentially hostile acquirers from gaining control of, or significant influence over, the reporting entity
- Buyout a partner or major stockholder’s ownership position

Figure 9-1 summarizes some of the more common methods reporting entities use to repurchase shares.

Figure 9-1
Types of share repurchase arrangements

<table>
<thead>
<tr>
<th>Repurchase type</th>
<th>Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward repurchase contract (FG 9.2.2)</td>
<td>Reporting entity agrees to purchase shares for a specified price on a specified date in the future</td>
</tr>
<tr>
<td>Spot repurchase (FG 9.2.3)</td>
<td>Reporting entity agrees to purchase shares at the prevailing market price</td>
</tr>
<tr>
<td>Accelerated share repurchase (ASR) (FG 9.2.4)</td>
<td>A transaction executed between a reporting entity and an investment bank in which the reporting entity repurchases a large number of shares at a purchase price determined by an average market price over a period of time</td>
</tr>
<tr>
<td>Written put option (FG 9.2.5)</td>
<td>Reporting entity must buy its shares at a specified price if the option holder elects to exercise its option</td>
</tr>
</tbody>
</table>
9.2.1 Recognition date of share repurchase transactions

A share repurchase arrangement accounted for as a liability within the scope of ASC 480, *Distinguishing Liabilities from Equity* should be recognized on its trade date. A share repurchase arrangement accounted for as a derivative within the scope of ASC 815, *Derivatives and Hedging* should also be recognized on its trade date. All other share repurchase arrangements should be accounted for on the settlement date of the transaction.

9.2.2 Forward repurchase contracts

A forward repurchase contract obligates the reporting entity to buy its own shares at a future date; therefore, it may be a liability within the scope of ASC 480. The accounting treatment for a forward repurchase contract depends on the settlement alternatives built into the contract and the nature of the reporting entity’s obligation to repurchase its shares. See FG 5.5 for information on ASC 480.

9.2.2.1 Physically settled forward repurchase contracts

A forward repurchase contract that, by its terms, must be physically settled by delivering cash in exchange for a fixed number of the reporting entity’s shares should be recorded as a liability under the guidance in ASC 480. ASC 480-10-30-3 through ASC 480-10-30-5 provide guidance regarding the initial measurement and recognition for such a physically settled forward repurchase contract. It is essentially accounted for as a financed purchase of treasury stock.

**ASC 480-10-30-3**

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.

**ASC 480-10-30-4**

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.

**ASC 480-10-30-5**

Equity shall be reduced by an amount equal to the fair value of the shares at inception.

To recognize a physically settled forward repurchase contract to buy a fixed number of shares for a fixed amount of cash, a reporting entity should debit treasury stock and credit a share repurchase (forward contract) liability based on the guidance in ASC 480-10-25-8 and ASC 480-10-30-5.

The subsequent measurement of a physically settled forward repurchase contract depends on whether the amount to be paid and the settlement date are fixed or can vary. ASC 480-10-35-3 provides
guidance regarding the subsequent measurement and recognition of a physically settled forward repurchase contract.

**ASC 480-10-35-3**

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.

To subsequently account for a physically settled forward contract with a fixed maturity date and a fixed price (common among forward repurchase contracts), a reporting entity should recognize the financing cost embedded in the forward repurchase contract by amortizing the discount to the forward price recorded at inception. To do this, a reporting entity should debit interest cost and credit the share repurchase (forward contract) liability.

**Earnings per share**

Accounting for a forward share repurchase contract as a financed purchase of treasury stock is appropriate only when the contract requires the delivery of a fixed number of shares for cash at settlement. When those conditions are met, the shares underlying the forward contract should be removed from weighted average common shares outstanding for purposes of calculating both basic and diluted earnings per share.

**Application example**

Example 9-1 illustrates the accounting for a fixed rate, physically settled forward repurchase contract that settles on a specific date.

**EXAMPLE 9-1**

Accounting for a physically settled fixed rate forward repurchase contract that settles on a specific date

FG Corp enters into a forward repurchase contract with a bank. FG Corp is required to physically settle the contract. It must pay cash to the bank in exchange for the shares.

Under the terms of the forward contract, FG Corp is obligated to purchase 1,000 shares of its own stock at a price of $125 per share in one year (total settlement price is 1,000 shares × $125 = $125,000). FG Corp’s stock price on the date the contract is entered into is $122.50; therefore, there is a financing cost of $2,500 embedded in the forward contract as discussed in FG 9.2.2.1. FG Corp calculates the amount of amortization for the first quarter as $600.
At the inception of the contract, FG Corp accounts for the trade as a financed purchase of treasury shares.

How does FG Corp measure and record the physically settled forward repurchase contract (a) at commencement of the forward repurchase contract, (b) in its quarterly financial statements three months after entering into the forward contract, and (c) at settlement?

*Analysis*

To record the physically settled forward repurchase contract at inception, FG Corp records a reduction in equity equal to the current fair value of the shares underlying the contract ($122.50 \times 1,000 \text{ shares} = $122,500) and a corresponding share repurchase liability.

<table>
<thead>
<tr>
<th>Dr. Treasury stock</th>
<th>$122,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Share repurchase liability</td>
<td>$122,500</td>
</tr>
</tbody>
</table>

To prepare its quarterly financial statements three months after entering into the forward contract, FG Corp calculates the quarterly amortization of the $2,500 discount created at inception using the effective yield approach.

FG Corp records the amortization to the share repurchase liability with an offsetting entry to interest expense.

<table>
<thead>
<tr>
<th>Dr. Interest expense</th>
<th>$600</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Share repurchase liability</td>
<td>$600</td>
</tr>
</tbody>
</table>

Upon settlement of the forward repurchase contract, FG Corp records the payment of cash to the bank to settle the share repurchase liability.

| Dr. Share repurchase liability | $125,000 |
| Cr. Cash                      | $125,000 |

FG Corp should also consider whether the forward repurchase contract has an effect on its earnings per share. Since the forward contract is accounted for as a financed purchased of treasury stock within the scope of ASC 480, the shares underlying the forward contract should be deducted from weighted average common shares outstanding when calculating basic and diluted earnings per share from inception of the forward repurchase contract.

ASC 480-10-55-14 through ASC 480-10-55-17 provide another example of how a physically settled fixed rate and date forward repurchase contract should be measured and accounted for at inception and in subsequent periods.

*9.2.2.2 Net cash or net share settled forward repurchase contracts*

A forward repurchase contract that permits or requires net cash settlement is a liability within the scope of ASC 480 because the reporting entity may be required to settle the obligation by transferring assets. Similarly, a forward repurchase contract that permits or requires net share settlement is a
liability because it obligates the reporting entity to deliver a variable number of shares that have a monetary value that moves inversely with changes in the fair value of the reporting entity’s stock price.

A net cash or net share settled forward repurchase contract should be initially, and subsequently, measured at fair value. Changes in the fair value of the forward repurchase contract should be recorded in net income. A net cash or net share settled forward repurchase contract may be classified as an asset or liability depending on the relationship between the contract price and the current forward price of the shares.

**Earnings per share**

A reporting entity should not deduct the shares underlying a net cash or net share settled forward repurchase contract from weighted average common shares outstanding for purposes of calculating basic and diluted earnings per share. That treatment is only applicable to forward contracts that require the delivery of a fixed number of shares for a fixed amount of cash at settlement.

A net cash or net share settled forward repurchase contract which, by its terms, may be settled in cash or shares should be included in diluted earnings per share using the guidance for contracts that may be settled in cash or shares in ASC 260-10-45-45 (see FSP 7.5.1 for additional information). Additionally, these contracts may be anti-dilutive (see FSP 7.5.1 for information on anti-dilutive instruments).

### 9.2.3 Spot repurchases

A reporting entity may choose to execute a share repurchase by acquiring its common shares in the open market (a spot repurchase). A spot repurchase transaction may be executed by the reporting entity or through a broker for regular-way settlement (typically 2–3 days).

A spot repurchase agreement that (1) unconditionally obligates a reporting entity to repurchase a fixed number of its own shares in exchange for cash and (2) requires physical settlement should be accounted for as a liability under ASC 480. A spot repurchase transaction that conditionally obligates the reporting entity to repurchase its own shares is not within the scope of ASC 480. These contracts are generally accounted for as executory contracts. For example, a reporting entity may execute a spot repurchase by instructing a third party broker to purchase its shares in the open market at the prevailing market price up to a fixed-dollar amount. A broker-assisted trade is generally a conditional obligation because the reporting entity has the ability to terminate any portion of the unfulfilled order. Therefore, in most cases, broker-assisted spot repurchase transactions do not fall within the scope of ASC 480.

If at any point the reporting entity is unconditionally obligated to purchase a fixed number of its shares for a fixed amount of cash (e.g., upon the broker executing a purchase of some or all of the shares pursuant to the order), recognition of a liability with a corresponding reduction of treasury stock may be appropriate based on the guidance in ASC 480. In practice, such transactions are generally limited to a relatively small number of shares and settlement occurs within a short period of time (e.g., two days). Therefore, they should be evaluated for materiality given the number of shares purchased, the amount owed to the broker, and whether the settlement period crosses a reporting period.
9.2.4 *Accelerated share repurchase (ASR) programs*

An accelerated share repurchase (ASR) program is a transaction executed by a reporting entity with an investment bank counterparty. An ASR allows the reporting entity to immediately purchase a large number of shares at a purchase price determined by an average market price over a period of time. The average market price is generally the volume weighted average price (VWAP), which is an objectively determinable market price. One of the primary advantages of an ASR is that it enables the reporting entity to execute a large treasury stock purchase immediately, while paying a purchase price that mirrors the price achieved by a longer-term repurchase program in the open market.

In its most basic form, an ASR program comprises the following two transactions:

- A treasury stock purchase in which the reporting entity buys a fixed number of shares and pays the investment bank counterparty the spot share price at the repurchase date.

- A contract under which the reporting entity either receives or delivers cash or shares (generally at the reporting entity’s option) at the contract’s maturity date. The reporting entity receives value (equal to the difference between the VWAP over the term of the contract and the spot share price multiplied by the number of shares purchased) from the bank if the VWAP is less than the spot share price paid at inception and delivers value to the bank if the VWAP is greater than the spot share price paid at inception.

Many ASR programs have terms that vary from this basic transaction and include additional features that are quite common but may complicate the accounting analysis. Figure 9-2 describes some of the more common terms or features.

**Figure 9-2**

*Common ASR terms and features*

<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
</tr>
</thead>
</table>
| Fixed dollar vs. fixed share | □ In a fixed dollar ASR, the proceeds paid by the reporting entity are fixed and the number of shares received varies based on the VWAP.  
□ In a fixed share ASR, the number of shares purchased is fixed and the amount paid for those shares varies based on the VWAP. |
| Fixed vs. variable maturity  | □ A fixed maturity ASR has a stated maturity date.  
□ In a variable maturity ASR, the investment bank has the option to choose the maturity date of the ASR, subject to a minimum and maximum maturity. The investment bank pays a premium (which generally takes the form of a discount on the share repurchase price) for this option.  
□ In a variable maturity, capped, or collared ASR contract, amounts received (paid) are determined based on a settlement formula. |
<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uncollared, capped, or</td>
<td>□ In an uncollared ASR, the reporting entity participates in all changes in VWAP over the term of the ASR.</td>
</tr>
<tr>
<td>collared pricing</td>
<td>□ In a capped ASR, the reporting entity participates in changes in VWAP subject to a cap, which limits the price the reporting entity will pay to repurchase the shares. A cap protects the reporting entity from paying a price for its shares above what it believes to be reasonable. The reporting entity pays the investment bank a premium for this protection.</td>
</tr>
<tr>
<td></td>
<td>□ In a collared ASR, the reporting entity participates in changes in VWAP subject to a cap and a floor. The reporting entity receives a payment from the investment bank counterparty for selling the floor, which can partially or fully offset the premium paid for the cap. The cap protects the reporting entity from paying a price for its shares above what it believes to be reasonable, and the floor limits the benefit the reporting entity receives from a declining share price.</td>
</tr>
<tr>
<td>Share holdback</td>
<td>□ In an effort to avoid legal and earnings per share complications that arise when a reporting entity delivers shares upon settlement of the forward contract, many reporting entities elect to receive fewer shares than they are entitled to at contract inception. In some cases, the reporting entity may receive staggered partial share deliveries over the term of the forward contract. The partial delivery of shares reduces the likelihood of the reporting entity being required to deliver shares back to the bank to settle the forward contract.</td>
</tr>
</tbody>
</table>

Despite these alternatives, all ASR transactions follow the same basic framework, depicted in Figure 9-3.
Figure 9-3
Illustration of ASR mechanics

Trade date

1. At trade date, the bank borrows the issuer’s shares from the stock lenders (parties independent of the issuer) at the spot price. Often the bank will provide cash collateral to the stock lenders, who are typically institutional investors.

2. The issuer makes a cash payment to the bank and all or a portion of the borrowed shares are delivered to the issuer (by the bank).

3. The issuer agrees to a future settlement based on a VWAP. This is also known as the forward contract (or make-up contract) of the ASR program.

Averaging or repurchase period

4. During the repurchase period, the bank purchases shares in the open market.

5. The shares are returned to the stock lenders to settle the bank’s share borrowings.

Maturity and settlement date

6. At the settlement date (or maturity) the issuer settles the ASR contract based on its terms.

Generally, if the VWAP during the averaging period is less than the issuer’s stock price at trade date, the issuer will have paid a lower price for its shares through the ASR than it would have in a spot repurchase at trade date. If the VWAP during the averaging period is higher than the issuer’s stock price at trade date, the issuer will have paid a higher price for its shares through the ASR than it would have in a spot repurchase at the trade date.
9.2.4.1 Initial recognition and measurement

An ASR is generally accounted for as two separate transactions (1) a treasury stock transaction and (2) an equity-linked contract on the reporting entity's own stock (ASR contract). See FG 9.3 for information on accounting for treasury stock transactions.

The ASR contract should first be analyzed to determine whether it should be classified as a liability per ASC 480-10-25-14. An instrument requiring delivery of a variable number of shares is classified as a liability if, at inception, the monetary value of the obligation is based solely or predominantly on (1) a fixed monetary amount known at inception or (2) variations inversely related to changes in the fair value of the reporting entity's equity shares.

In the basic ASR transaction described in FG 9.2.4, a reporting entity could be required to deliver a variable number of shares at maturity of the ASR contract. In this case, the monetary value received or delivered would be equal to (a) the difference between the VWAP over the term of the contract and the spot share price, multiplied by (b) the number of shares purchased at inception. Since the monetary value changes as the VWAP changes, it is not predominantly based on a fixed monetary amount. In addition, the reporting entity could be required to deliver value as the price of its shares (i.e., the VWAP) increases and could receive value as the price of its shares decreases. Therefore, the monetary value is not based on variations inversely related to changes in the fair value of the reporting entity's equity shares.

The monetary value of an ASR contract that incorporates alternatives to the basic structure may be more complicated to determine. Frequently, a quantitative analysis (or predominance test) of the possible settlement outcomes is needed to determine how the monetary value is affected by the terms of the transaction. For example, a variable maturity option reduces the value of the contract from the perspective of the reporting entity. In other words, this feature behaves like a written put option. In the case of an ASR with a variable maturity option, the quantitative analysis may be designed to determine whether the written put component resulting from the variable maturity option is a predominant feature of the population of settlement alternatives. If it is, then the ASR contract may be within the scope of ASC 480.

A quantitative analysis may take into account factors such as:

- The terms of the contract, including the number of shares delivered at inception of the transaction
- The reporting entity's stock price at the trade date
- The volatility of the reporting entity's stock price
- The probability of any cap or floor on the ASR contract being reached

If a reporting entity concludes that an ASR contract is not within the scope of ASC 480, the next step is to determine whether it should be classified as a liability or equity under the guidance in ASC 815-40, Contracts in Entity's Own Equity. See FG 5.6 for further information on the analysis of a freestanding equity-linked instrument.

If it is determined that the ASR contract should be classified in equity, the reporting entity should record it in additional paid-in capital at its fair value. See Example 9-2 for an illustration of this
guidance. If the ASR contract should be classified as a liability, the reporting entity should record the contract at fair value with changes in fair value recorded in net income.

### 9.2.4.2 Settlement of an ASR contract classified in equity

When an ASR contract is settled in cash, the cash payment should be recorded in additional paid-in capital because it is a payment to settle an equity classified contract. Similarly, when an ASR contract is settled in shares, the shares should be recorded at fair value in additional paid-in capital because they are issued (or received) to settle an equity classified contract.

Figure 9-4 summarizes the accounting treatment for the various settlement alternatives of an ASR contract.

### Figure 9-4
Summary of ASR settlement alternatives

<table>
<thead>
<tr>
<th>Settlement form</th>
<th>Party owing value</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Bank</td>
<td>Cash payment should be recorded as an increase to additional paid-in capital</td>
</tr>
<tr>
<td>Cash</td>
<td>Reporting entity</td>
<td>Cash payment should be recorded as a reduction of additional paid-in capital</td>
</tr>
<tr>
<td>Shares</td>
<td>Bank</td>
<td>Shares should be recorded in treasury stock with an offsetting entry to additional paid-in capital; generally, issuers record the shares at fair value</td>
</tr>
<tr>
<td>Shares</td>
<td>Reporting entity</td>
<td>If the reporting entity issues new shares, the shares should be recorded at fair value with an offsetting entry to additional paid-in capital. If the reporting entity reissues treasury shares, the guidance for the reissuance of treasury shares should be applied; see FG 9.3.2 for information on the reissuance of treasury stock</td>
</tr>
</tbody>
</table>

If neither the reporting entity nor the investment bank owes value, there should be no accounting entry. The fair value of the equity classified ASR contract should remain in additional paid-in capital.

### 9.2.4.3 Earnings per share

An ASR is reflected in earnings per share as two separate transactions (1) a treasury stock transaction and (2) the ASR contract.

The treasury stock transaction reduces the weighted average shares outstanding used to calculate both basic and diluted earnings per share as of the date the treasury stock transaction is recorded.
The ASR contract is generally included in diluted earnings per share using the treasury stock method; however, the reporting entity should consider (1) the terms of the specific ASR program and (2) the reporting entity’s specific facts and circumstances to determine the appropriate earnings per share treatment. Most ASR contracts give the reporting entity the option to elect to receive, or pay, any value owed under the ASR contract at maturity in cash or shares. If a reporting entity has established a pattern of settling such ASR contracts in cash, the treasury stock method may not be appropriate based on the guidance in ASC 260-10-55-32 through ASC 260-10-55-36A for instruments settleable in cash or shares. See FSP 7.5.7.1 for further information.

The reporting entity should also consider whether the terms of an ASR contract require it to be accounted for as a participating security. In many ASR contracts, the dividends expected to be paid during the term of the ASR contract are included in the forward price. If the reporting entity pays dividends in excess of the expected dividends, this will adversely impact the economics of the ASR transaction for the bank counterparty. To protect against this, the bank counterparty will typically have an option to terminate the ASR contract upon the declaration of the “excess” dividend. If instead, the ASR contract protects the bank counterparty by requiring the reporting entity to pay the difference between the expected and actual dividends paid during the term of the ASR contract to the bank counterparty, the ASR contract is a participating security and application of the two-class method of calculating earnings per share should be applied. See FSP 7.4.2 for information on participating securities and the two-class method of calculating earnings per share.

9.2.4.4 Application example

Example 9-2 illustrates the accounting for an ASR contract.

EXAMPLE 9-2

Accounting for an ASR contract

On September 30, 20X5, when its stock price is $125 per share, FG Corp enters into an ASR program with the following terms:

- The ASR is a fixed dollar program in which FG Corp will deliver $10 million to the bank on September 30, 20X5 to repurchase a variable number of shares. The variable number of shares will be determined by dividing the $10 million contract amount by the VWAP observed during the term of the ASR contract.

- The bank delivers 76,000 shares to FG Corp on September 30, 20X5.

- FG Corp is not obligated to deliver any cash to the bank after the initial cash delivery of $10 million. FG Corp analyzes the ASR contract and determines that it is not a liability within the scope of ASC 480. In addition, FG Corp concludes that the contract meets the requirements for equity classification. The fair value of the ASR contract after the cash payment and initial share delivery is $500,000 [($10 million – (76,000 shares x $125)].

The contract matures on March 31, 20X6, and the VWAP over the ASR term is $117.00. At maturity, FG Corp receives an additional 9,470 shares ([($10 million ÷ $117 = 85,470] less 76,000 initial share delivery), at which time FG Corp's stock price is $110 per share.

What journal entries should FG Corp record at the inception and settlement of the ASR transaction?
Analysis

When FG Corp enters into the ASR contract, it should record (1) treasury stock equal to the shares repurchased multiplied by the then current stock price (76,000 × $125 = $9,500,000), (2) the fair value of the ASR contract in additional paid-in capital, and (3) the cash payment made.

Dr. Treasury stock $9,500,000
Dr. Equity – additional paid-in capital $500,000
Cr. Cash $10,000,000

When FG Corp settles the ASR contract, it should record (1) treasury stock equal to the shares received multiplied by the current stock price (9,470 × $110 = $1,041,700) and (2) an offsetting entry to additional paid-in capital.

Dr. Treasury stock $1,041,700
Cr. Equity – additional paid-in capital $1,041,700

9.2.5 Written put option

When a reporting entity writes a put option on its own shares, it agrees to buy the shares from a counterparty, generally in exchange for cash, when its share price falls below a specified price. In return, the counterparty pays the reporting entity a premium for entering into the written put option. Generally, a put option has a strike price below the share price at inception (i.e., it is out-of-the-money).

Regardless of the form of settlement, a written put option on a reporting entity’s own shares is a liability within the scope of ASC 480. See FG 5.5 for further information on the scope of ASC 480.

A written put option on a reporting entity’s own shares should be recorded at fair value with changes in fair value recorded in net income.

9.2.5.1 Earnings per share

To determine how a written put option should be included in diluted earnings per share, a reporting entity should determine whether the written put option will be settled in cash or shares. If the written put option will be settled in shares, it should be included in diluted earnings per share using the reverse treasury stock method. See FSP 7.5.7.1 for information on instruments settleable in cash or shares and FSP 7.5.5.9 for information on the reverse treasury stock method.

9.3 Treasury stock

As discussed in ASC 505-30, Treasury Stock, when a reporting entity repurchases its shares it may account for the shares as treasury stock or retire them. See FG 9.4 for information on share retirement.

ASC 505-30-30-6 provides guidance on recording treasury stock.
**9.3.1 Accounting for the purchase of treasury stock**

A reporting entity should recognize treasury stock based on the amount paid to repurchase its shares. It should be recorded as a reduction of stockholders’ equity (i.e., as a contra-equity account). Since treasury stock is not considered outstanding for share count purposes, it should be excluded from average common shares outstanding for basic and diluted earnings per share.

Although the cost of the treasury stock is generally the price paid for the shares, a reporting entity should consider whether the price paid for the shares includes payment for other agreements, rights, and privileges. See FG 9.3.4 for further information on multiple element treasury stock transactions. Direct costs incurred to acquire treasury stock should be treated like stock issue costs and added to the cost of the treasury stock by analogy to the guidance provided in the AICPA TIS Section 4110.09.

**9.3.2 Accounting for reissuance of treasury stock**

When a reporting entity reissues treasury stock at an amount greater (less) than it paid to repurchase the shares (based on its policy such as average cost, FIFO, LIFO, or specific identification), it realizes a gain (loss) on the reissuance of the shares. This gain or loss should be recognized in shareholders’ equity, not net income. A gain on the reissuance of treasury shares should be credited to additional paid-in capital. A loss on the reissuance of treasury shares may be debited to additional paid-in capital to the extent previous net gains from sales or retirements of the same class of stock are included in additional paid-in capital. Any losses in excess of that amount should be charged to retained earnings.

**9.3.3 Application example**

Example 9-3 illustrates the accounting for the purchase and subsequent reissuance of treasury stock.

**EXAMPLE 9-3**

*Accounting for the purchase and subsequent reissuance of treasury stock*

FG Corp repurchases 2,000 shares of its common stock at a price of $40 per share. The shares are recorded as treasury stock and are not formally retired.

Six months after purchasing the treasury shares, FG Corp reissues 1,000 shares of treasury stock at a price of $45 per share. The remaining 1,000 shares of treasury stock are reissued two months after that at a price of $28 per share.
How should FG Corp account for the purchase and reissuance of treasury stock?

*Analysis*

When FG Corp executes the treasury stock purchase, it should record the treasury shares based on its cost (2,000 shares x $40) by recording the following journal entry.

<table>
<thead>
<tr>
<th>Dr. Treasury stock</th>
<th>$80,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Cash</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

When FG Corp reissues 1,000 shares of treasury stock for $45 per share, it should reduce treasury stock for an amount equal to the initial cost and record the reissuance gain in additional paid-in capital (1,000 shares x $5) by recording the following journal entry.

<table>
<thead>
<tr>
<th>Dr. Cash</th>
<th>$45,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Treasury stock</td>
<td>$40,000</td>
</tr>
<tr>
<td>Cr. Additional paid-in capital</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

When FG Corp reissues the remaining 1,000 shares of treasury stock at $28 per share, it should reduce treasury stock at an amount equal to its initial cost (1,000 shares x $40) and record the reissuance loss in additional paid-in capital to the extent of prior reissuance gains ($5,000). The remaining reissuance loss [(1,000 shares x ($40-$28)) - $5,000] should be charged to retained earnings by recording the following journal entry.

<table>
<thead>
<tr>
<th>Dr. Cash</th>
<th>$28,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Additional paid-in capital</td>
<td>$5,000</td>
</tr>
<tr>
<td>Dr. Retained earnings</td>
<td>$7,000</td>
</tr>
<tr>
<td>Cr. Treasury stock</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

Question 9-1 discusses how a reporting entity with an accumulated deficit should record a loss on the reissuance of treasury stock.

**Question 9-1**

How should a reporting entity with an accumulated deficit record a loss on the reissuance of treasury stock?

**PwC response**

We believe a reporting entity with an accumulated deficit should analogize to the guidance in SAB Topic 3.C, *Redeemable Preferred Stock* (as codified in ASC 480-10-S99-2), and record a loss on the reissuance of treasury stock to additional paid-in capital until there is none left. Once additional paid-in capital has been depleted, additional losses should be recorded by increasing the accumulated deficit.
9.3.4 Multiple element treasury stock transactions

Sometimes, the facts and circumstances of a share repurchase suggest that the transaction involves more than the purchase of treasury stock. For example, a reporting entity may repurchase shares at a price greater, or less than, fair value. As discussed in ASC 505-30-30-3, when a reporting entity pays more than the fair value of the acquired treasury stock, the excess should be attributed to the other elements of the transaction.

Excerpt from ASC 505-30-30-3

The price paid in excess of the amount accounted for as the cost of the 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 the 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.

The cost of a public company’s treasury stock should generally be the quoted market price of the shares. The SEC staff has generally objected to the use of other valuation methods.

The cost of private company shares may be more subjective. A reporting entity should consider the facts and circumstances to determine whether the amount paid includes stated or unstated consideration for other elements. If there are no other elements to be accounted for separately, we believe the entire amount paid to acquire treasury shares should be included in the recorded cost.

9.3.4.1 Treasury stock transactions involving a standstill agreement

A reporting entity may enter into a standstill agreement as a hostile takeover defense mechanism. A standstill agreement precludes a hostile bidder from purchasing additional shares of the reporting entity’s stock for a specified period of time.

Often, the reporting entity also agrees to repurchase its shares from the bidder at a later date, typically at a premium. These agreements are commonly referred to as “greenmail transactions.” When a reporting entity agrees to buy back its shares at a premium, it should separate the amount paid into (1) the cost to defend itself from a takeover attempt, and (2) the cost to repurchase its shares. Costs incurred to defend itself from a takeover attempt, including any premium paid to a hostile bidder, should be expensed as incurred, as required by ASC 505-30-25-4, as normal operating costs.

9.3.4.2 Litigation settlements involving the purchase of shares

A litigation settlement may involve a purchase of shares. For example, a reporting entity may purchase its shares from an existing shareholder at a price in excess of its then fair value at the time it agrees to settle pending litigation. If the substance of an arrangement is that the reporting entity is settling litigation with a shareholder, then the excess value should be attributed to the litigation settlement.
9.3.4.3  **Repurchases of stock held by employees at other than fair value**

When a reporting entity repurchases its shares from employees as part of an employee stock ownership or other arrangement, the reporting entity should assess whether the price paid results in compensation expense. See SC 1.13.4.1 for information on repurchases of shares from an employee.

9.3.5  **Dividends on treasury stock**

Typically, cash dividends are not declared and paid on treasury stock unless the treasury shares are underlying a forward share repurchase contract. If a reporting entity does declare a cash dividend on treasury stock that it holds, the dividend should be deducted from the dividend distribution and should not be recorded as investment income. That is, the entry to charge retained earnings and credit cash for the dividends paid on treasury stock is eliminated since the cash remains with the reporting entity.

9.3.5.1  **Stock dividends on treasury stock**

Applicable state laws govern the issuance of stock dividends on treasury stock. Some statutes prohibit this practice. When treasury stock is not retired and is held with the expectation that it will be reissued for a specific purpose (e.g., stock option, purchase, or bonus plans), it may be important to maintain the same ratio of treasury shares to total shares outstanding before and after a stock dividend. In that case, issuance of a stock dividend on treasury stock may be appropriate if permitted by law. When the ratio of treasury shares to total shares does not need to be retained, issuance of stock dividends on the treasury stock is not necessary.

We believe a reporting entity should record the dividend using the legal minimum. However, in some cases, recording a stock dividend at the legal minimum may conflict with stock exchange or regulatory authority requirements. In that case, the reporting entity may record the dividend applicable to treasury stock at the fair value of the dividend shares. See FG 7.7.1 for further information on stock dividends.

The cost basis of shares recorded as treasury stock does not change based on how the reporting entity recorded the dividend. The original cost to acquire the treasury stock should be allocated to the total number of shares held in treasury, including the dividend shares.

9.3.6  **Treasury stock issued to pay a stock dividend**

When treasury stock is issued to pay all or a portion of a stock dividend, the dividend should be recorded at an amount equal to the fair value of the shares on the dividend declaration date. The reissuance of the treasury shares should be accounted for in the same manner as other reissuances of treasury stock. See FG 9.3.2 for information on the reissuance of treasury stock.

9.4  **Share retirement**

A reporting entity may decide, or be required by state law, to retire the shares it acquires. When shares are retired, the number of issued and outstanding shares decreases; retired shares are equivalent to authorized, unissued shares.

To retire shares, a reporting entity should debit the common stock account for an amount equal to the number of shares being retired multiplied by the par or stated value. ASC 505-30-30-8 provides
guidance on how to account for the amount paid to repurchase the shares in excess of the par or stated value. Figure 9-5 summarizes the methods described in ASC 505-30-30-8.

**Figure 9-5**
Methods of accounting for a repurchase price paid in excess of par or stated value

<table>
<thead>
<tr>
<th>Method</th>
<th>Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>Record the excess entirely in retained earnings</td>
</tr>
<tr>
<td>Retained earnings / additional paid-in capital</td>
<td>Allocate the excess between retained earnings and additional paid-in capital; the balance recorded in APIC is limited as discussed below</td>
</tr>
</tbody>
</table>

We also believe that the excess can be recorded entirely in additional paid-in capital (although the balance recorded to APIC is limited as discussed below). This method is not explicitly mentioned in ASC 505-30-30-8; however, it was contained in the guidance in ARB 43, and we believe it may still be applied.

If a reporting entity chooses to record an amount to additional paid-in capital, it should be limited as discussed in ASC 505-30-30-8.

**Excerpt from ASC 505-30-30-8**

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.

A reporting entity should elect one method and follow it consistently. The method elected should be disclosed in the reporting entity’s financial statements if considered to be a significant accounting policy.

If a reporting entity repurchases shares for retirement at a price less than the par or stated value, the difference between the par or stated value and the cost of the treasury stock should be credited to additional paid-in capital as discussed in ASC 505-30-30-9.

When a reporting entity retires shares, it should consider consulting legal counsel to make sure that its accounting entries and financial statements conform to applicable state laws, including whether the share retirement results in a reduction of the number of authorized shares.
Appendix A: Professional literature

The PwC guides provide in-depth accounting and financial reporting guidance for various topics, as outlined in the preface to this guide. The PwC guides summarize the applicable accounting literature, including relevant references to and excerpts from the FASB’s Accounting Standards Codification (the Codification). They also provide our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides supplement the authoritative accounting literature. This appendix provides further information on authoritative US generally accepted accounting principles.

Professional literature

The Codification is the primary source of authoritative US GAAP for nongovernmental reporting entities (hereinafter referred to as “reporting entities”). Additionally, guidance issued by the SEC is a source of authoritative guidance for SEC registrants.

Updates and amendments to the Codification arising out of the FASB’s standard-setting processes are communicated through Accounting Standards Updates (ASUs). The Codification is updated concurrent with the release of a new ASU, or shortly thereafter. PwC has developed a FASB Accounting Standards Codification Quick Reference Guide, which is available on CFOdirect. The quick reference guide explains the structure of the Codification, including examples of the citation format, how new authoritative guidance will be released and incorporated into the Codification, and where to locate other PwC information and resources on the Codification. The quick reference guide also includes listings of the Codification’s “Topics” and “Sections” and a list of frequently-referenced accounting standards and the corresponding Codification Topics where they now primarily reside.

In the absence of guidance for a transaction or event within a source of authoritative US GAAP (i.e., the Codification and SEC guidance), a reporting entity should first consider accounting principles for similar transactions or events within a source of authoritative US GAAP for that reporting entity and then consider non-authoritative guidance from other sources. Sources of non-authoritative accounting guidance and literature include:

- FASB Concepts Statements
- AICPA Issues Papers
- International Financial Reporting Standards issued by the International Accounting Standards Board
- Pronouncements of other professional associations or regulatory agencies Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
- PwC accounting and financial reporting guides
- Accounting textbooks, guides, handbooks, and articles
Practices that are widely recognized and prevalent either generally or in the industry

While other professional literature can be considered when the Codification does not cover a certain type of transaction or event, we do not expect this to occur frequently in practice.

SEC guidance

The content contained in the SEC sections of the FASB’s Codification is provided for convenience and relates only to SEC registrants. The SEC sections do not contain the entire population of SEC rules, regulations, interpretative releases, and staff guidance. Also, there is typically a lag between when SEC guidance is issued and when it is reflected in the SEC sections of the Codification. Therefore, reference should be made to the actual documents published by the SEC and SEC staff when addressing matters related to public reporting entities.
Appendix B: Technical references and abbreviations

The following tables provide a list of the technical references and definitions for the abbreviations and acronyms used within this guide.

Technical references

<table>
<thead>
<tr>
<th>Reference</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARB 43</td>
<td>Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins</td>
</tr>
<tr>
<td>ASC 260</td>
<td>Accounting Standards Codification 260, Earnings Per Share</td>
</tr>
<tr>
<td>ASC 310</td>
<td>Accounting Standards Codification 310, Receivables</td>
</tr>
<tr>
<td>ASC 323</td>
<td>Accounting Standards Codification 323, Equity Method and Joint Ventures</td>
</tr>
<tr>
<td>ASC 326</td>
<td>Accounting Standards Codification 326, Credit Losses</td>
</tr>
<tr>
<td>ASC 340</td>
<td>Accounting Standards Codification 340, Other Assets and Deferred Costs</td>
</tr>
<tr>
<td>ASC 405</td>
<td>Accounting Standards Codification 405, Liabilities</td>
</tr>
<tr>
<td>ASC 450</td>
<td>Accounting Standards Codification 450, Contingencies</td>
</tr>
<tr>
<td>ASC 460</td>
<td>Accounting Standards Codification 460, Guarantees</td>
</tr>
<tr>
<td>ASC 470</td>
<td>Accounting Standards Codification 470, Debt</td>
</tr>
<tr>
<td>ASC 480</td>
<td>Accounting Standards Codification 480, Distinguishing Liabilities from Equity</td>
</tr>
<tr>
<td>ASC 505</td>
<td>Accounting Standards Codification 505, Equity</td>
</tr>
<tr>
<td>ASC 606</td>
<td>Accounting Standards Codification 606, Revenue from Contracts with Customers</td>
</tr>
<tr>
<td>ASC 718</td>
<td>Accounting Standards Codification 718, Compensation – Stock Compensation</td>
</tr>
<tr>
<td>ASC 805</td>
<td>Accounting Standards Codification 805, Business Combinations</td>
</tr>
<tr>
<td>ASC 810</td>
<td>Accounting Standards Codification 810, Consolidation</td>
</tr>
</tbody>
</table>
### Technical references

<table>
<thead>
<tr>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 815</td>
<td>Accounting Standards Codification 815, <em>Derivatives and Hedging</em></td>
</tr>
<tr>
<td>ASC 820</td>
<td>Accounting Standards Codification 820, <em>Fair Value Measurement</em></td>
</tr>
<tr>
<td>ASC 825</td>
<td>Accounting Standards Codification 825, <em>Financial Instruments</em></td>
</tr>
<tr>
<td>ASC 835</td>
<td>Accounting Standards Codification 835, <em>Interest</em></td>
</tr>
<tr>
<td>ASC 840</td>
<td>Accounting Standards Codification 840, <em>Leases</em></td>
</tr>
<tr>
<td>ASC 845</td>
<td>Accounting Standards Codification 845, <em>Nonmonetary Transactions</em></td>
</tr>
<tr>
<td>ASC 850</td>
<td>Accounting Standards Codification 850, <em>Related Party Disclosures</em></td>
</tr>
<tr>
<td>ASC 860</td>
<td>Accounting Standards Codification 860, <em>Transfers and Servicing</em></td>
</tr>
<tr>
<td>ASC 944</td>
<td>Accounting Standards Codification 944, <em>Insurance</em></td>
</tr>
<tr>
<td>ASC 970</td>
<td>Accounting Standards Codification 970, <em>Real Estate – General</em></td>
</tr>
<tr>
<td>ASR 268</td>
<td>Accounting Series Release No. 268, <em>Presentation in Financial Statements of &quot;Redeemable Preferred Stocks&quot;</em></td>
</tr>
<tr>
<td>CON 6</td>
<td>FASB Statement of Financial Accounting Concepts No. 6 – <em>Elements of Financial Statements</em></td>
</tr>
<tr>
<td>EITF No. 00-27</td>
<td>Emerging Issues Task Force No. 00-27, <em>Application of Issue No. 98-5 to Certain Convertible Instruments</em></td>
</tr>
<tr>
<td>FRP 214</td>
<td>SEC Financial Reporting Policy 214, <em>Pro Rata Stock Distributions to Shareholders</em></td>
</tr>
<tr>
<td>NYSE Manual Section 703</td>
<td>NYSE Manual Section 703, <em>Subsequent Listing Applications and Debt Securities Applications</em></td>
</tr>
<tr>
<td>SAB Topic 5.Q</td>
<td>Staff Accounting Bulletin Topic 5.Q, <em>Increasing Rate Preferred Stock</em></td>
</tr>
<tr>
<td>Acronym</td>
<td>Definition</td>
</tr>
<tr>
<td>---------</td>
<td>------------</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>APIC</td>
<td>Additional paid-in capital</td>
</tr>
<tr>
<td>ARB</td>
<td>Accounting Research Bulletin</td>
</tr>
<tr>
<td>ASC</td>
<td>Accounting Standards Codification</td>
</tr>
<tr>
<td>ASR</td>
<td>Accelerated share repurchase</td>
</tr>
<tr>
<td>ASU</td>
<td>Accounting Standards Update</td>
</tr>
<tr>
<td>BCF</td>
<td>Beneficial conversion feature</td>
</tr>
<tr>
<td>CON</td>
<td>Statements of Financial Accounting Concepts</td>
</tr>
<tr>
<td>EBITDA</td>
<td>Earnings before interest, taxes, depreciation, and amortization</td>
</tr>
<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>EPS</td>
<td>Earnings per share</td>
</tr>
<tr>
<td>FAQ</td>
<td>Frequently asked questions</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FIFO</td>
<td>First-in, first-out</td>
</tr>
<tr>
<td>FRP</td>
<td>SEC Financial Reporting Policies</td>
</tr>
<tr>
<td>FVO</td>
<td>Fair value option</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally accepted accounting principles</td>
</tr>
<tr>
<td>LIFO</td>
<td>Last-in, first-out</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>National Association of Securities Dealers Automated Quotations</td>
</tr>
<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
</tr>
<tr>
<td>PIK</td>
<td>Payment in kind</td>
</tr>
<tr>
<td>PV</td>
<td>Present value</td>
</tr>
<tr>
<td>SAB</td>
<td>Staff Accounting Bulletin</td>
</tr>
<tr>
<td>SEC</td>
<td>United States Securities &amp; Exchange Commission</td>
</tr>
<tr>
<td>Acronym</td>
<td>Definition</td>
</tr>
<tr>
<td>---------</td>
<td>--------------------------------</td>
</tr>
<tr>
<td>TDR</td>
<td>Troubled debt restructuring</td>
</tr>
<tr>
<td>VIE</td>
<td>Variable interest entity</td>
</tr>
<tr>
<td>VWAP</td>
<td>Volume weighted average price</td>
</tr>
</tbody>
</table>
## Appendix C: Key terms

The following table provides definitions for key terms used within this guide.

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Accelerated share repurchase</strong></td>
<td>A transaction executed by a company with a bank counterparty that allows the company to buy a large number of shares immediately at a purchase price determined by an average market price over a subsequent period of time. One of the primary objectives of an ASR is to enable the company to execute a large treasury stock purchase immediately, while paying a purchase price that mirrors the price achieved by a longer-term repurchase program in the open market.</td>
</tr>
<tr>
<td><strong>Beneficial conversion feature</strong></td>
<td>A non-detachable conversion feature that is in the money at the commitment date.</td>
</tr>
<tr>
<td><strong>Callable</strong></td>
<td>Subject to redemption prior to maturity.</td>
</tr>
</tbody>
</table>
| **Call option** | If a company *buys* a call option on its own equity, the call option provides the company with the right, but not the obligation, to buy a specified quantity of its shares from the counterparty (call option seller) to the contract at a fixed price for a given period.  

If a company *sells* a call option on its own equity, the call option obligates the company to sell a specified quantity of its shares to the counterparty (call option buyer) to the contract at a fixed price for a given period. A warrant is economically equivalent to a sold call option.  

A call option embedded in a debt instrument provides the issuer (borrower) with the right to repay its debt on demand prior to the stated maturity date. |
| **Call option overlay (call spread or capped call)** | A transaction between a convertible bond issuer and a bank whereby the issuer purchases a call option from the bank which mirrors the conversion option embedded in the issuer’s convertible bond, effectively “hedging,” or canceling, the embedded conversion option. The issuer then sells a call option to the bank, almost always at a higher strike price than the embedded conversion option and purchased call option, effectively raising the strike price of the convertible bond transaction.  

A call option overlay may be executed as two separate call option transactions (a “call spread”) or it can be executed as a single integrated transaction (a “capped call”). |
<p>| <strong>Call premium</strong> | The amount above the par value of an instrument that its issuer must pay to the holders if the instrument is redeemed before its maturity date, or the amount the purchaser of a call option must pay to the writer. |</p>
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change-in-control put</td>
<td>A contingently exercisable put option embedded in a debt instrument that provides the holder with the right to put the debt back to the issuer upon the occurrence of a fundamental change in the issuing entity (such as a change in control).</td>
</tr>
<tr>
<td>Commitment date</td>
<td>The date when an agreement has been reached that meets the definition of a firm commitment. If either party has the ability to rescind its commitment to complete the transaction, a commitment date does not occur until such provisions expire or the convertible instrument is issued, whichever is earlier. Typically, the commitment date does not occur until the date the convertible instrument is issued (i.e., the date cash and securities are exchanged).</td>
</tr>
<tr>
<td>Common stock</td>
<td>A stock that is subordinate to all other stock of the issuer. Also called common shares.</td>
</tr>
<tr>
<td>Contingently convertible instruments</td>
<td>Instruments that have embedded conversion options that are exercisable only upon the satisfaction of a contingency.</td>
</tr>
<tr>
<td>Convertible debt</td>
<td>Debt securities that provide the holder with the option to exchange the debt security for a specified number of the issuer’s equity securities.</td>
</tr>
<tr>
<td>Convertible preferred stock</td>
<td>Preferred securities that provide the holder with the option to exchange the security for a specified number of a different class of the issuer’s equity shares.</td>
</tr>
<tr>
<td>Credit derivative</td>
<td>A financial instrument used to transfer credit risk from the party exposed to that risk (the protection buyer) to a party willing to take on that risk (the protection seller). Its value is derived from the credit quality of a bond, loan or other financial obligation or group of financial obligations of an underlying reporting entity (reference entity). Examples of credit derivatives include credit default swaps, total return swaps, credit spread options, and credit index products.</td>
</tr>
<tr>
<td>Derivative instrument</td>
<td>A financial instrument that meets the definition of a derivative in ASC 815-10-15-83.</td>
</tr>
<tr>
<td>Detachable warrants</td>
<td>A detachable warrant is one that is originally issued in conjunction with another security (often debt) that may be exercised or traded separately following the issue date.</td>
</tr>
<tr>
<td>Discount</td>
<td>The difference between the net proceeds, after expense, received upon issuance and the amount repayable at maturity.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>-------------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Double-double test</td>
<td>A test to determine whether an embedded interest rate derivative is considered clearly and closely related to the debt host instrument. An embedded interest rate component is considered clearly and closely related (and does not need to be accounted for separately) unless certain conditions are true. The name of the “double-double” test is derived from the condition that requires analyzing whether the embedded interest provision could cause the doubling of both the initial interest rate and the current market rate of interest for a debt instrument of similar credit quality. In essence, if there is any possible scenario in which the investor could earn a future rate of return that is both double the initial rate of the host contract and double the then market interest rate of a debt instrument of similar credit quality, the embedded derivative would generally need to be accounted for separately from the debt host.</td>
</tr>
<tr>
<td>Embedded derivative</td>
<td>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.</td>
</tr>
<tr>
<td>Equity-linked instrument</td>
<td>A hybrid instrument that contains an embedded component linked to the equity of the issuer. The investor's return is dependent upon the performance of the underlying equity to which the instrument is linked. Including equity-linked component in a financing transaction frequently enables companies to lower cash interest costs. A convertible debt instrument is an example of an equity-linked instrument.</td>
</tr>
<tr>
<td>Forward contract</td>
<td>An agreement obligating two parties to buy or sell a specified quantity of an underlying security at a specified future date and price.</td>
</tr>
<tr>
<td>Freestanding financial instrument</td>
<td>A financial instrument that either (a) is entered into separately and apart from any of the entity’s other financial instruments or equity transactions or (b) is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.</td>
</tr>
<tr>
<td>Greenshoe or overallotment option</td>
<td>A freestanding agreement between an issuer and an underwriter which allows the underwriter to call additional securities to “upsise” the amount of securities issued (i.e., a 20% greenshoe on a $100 million convertible debt offering allows the underwriter to require the issuer to issue an additional $20 million of debt at par value).</td>
</tr>
<tr>
<td>Gross physical settlement/delivery</td>
<td>A form of settling a financial instrument under which (a) the party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller and (b) the seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Guarantee</td>
<td>A formal promise or assurance for the fulfillment of a certain condition. Common types of guarantees include financial guarantees, performance guarantees, indemnifications, and indirect guarantees of another entity's debt. Guarantees are often embedded in purchase or sales agreements, service contracts, joint venture agreements, or other commercial arrangements.</td>
</tr>
<tr>
<td>Host instrument</td>
<td>The non-derivative component of a hybrid instrument which “hosts” an embedded derivative feature.</td>
</tr>
<tr>
<td>Induced conversion</td>
<td>A transaction in which the issuer induces conversion of a convertible instrument by offering additional securities or other consideration (“sweeteners”) to investors.</td>
</tr>
<tr>
<td>Interest method</td>
<td>The method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt plus or minus the unamortized premium or discount at the beginning of each period.</td>
</tr>
<tr>
<td>In the money</td>
<td>A phrase that describes when an option is worth exercising. A call option is in the money when the option’s strike price is below the market price of the underlying asset. A put option is in the money when the strike price is above the market price of the underlying asset. When you have the right to either buy something below the current market price or sell something above its current market price, then that right has value and the instrument is said to be “in the money.” This is also referred to as intrinsic value.</td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>An option that is in the money has intrinsic value. When out of the money, its intrinsic value is zero. The intrinsic value for an in-the-money option is calculated as the absolute value of the difference between the current price of the underlying and the strike price of the option. Therefore, the intrinsic value is the in-the-money amount.</td>
</tr>
<tr>
<td>Line-of-credit (or revolving debt)</td>
<td>A line-of-credit or revolving debt arrangement is an agreement that provides the borrower 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).</td>
</tr>
<tr>
<td>Loan participation</td>
<td>A transaction in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to groups of banks or other entities.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>------</td>
<td>------------</td>
</tr>
<tr>
<td>Loan syndication</td>
<td>A transaction in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. It is common for groups of lenders to jointly fund those loans when the amount borrowed is greater than any one lender is willing to lend.</td>
</tr>
<tr>
<td>Mandatorily redeemable financial instrument</td>
<td>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.</td>
</tr>
<tr>
<td>Mandatory unit</td>
<td>Equity-linked financial products, often marketed under different proprietary names by different financial institutions (e.g., ACES, PRIDES, or DECS), which consist of a bundled transaction comprising both (a) term debt with a remarketing feature and (b) a detachable variable share forward delivery agreement.</td>
</tr>
<tr>
<td>Mezzanine equity</td>
<td>Mezzanine equity is presented after liabilities and before stockholders’ equity on the balance sheet. The purpose of this classification is to convey that such a security may not be permanently part of equity and could result in a demand for cash or other assets of the entity in the future.</td>
</tr>
<tr>
<td>Net carrying amount of debt</td>
<td>Net carrying amount of debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.</td>
</tr>
<tr>
<td>Net cash settlement</td>
<td>A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain cash equal to the gain.</td>
</tr>
<tr>
<td>Net share settlement</td>
<td>A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain shares of stock with a current fair value equal to the gain.</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent; noncontrolling interest is sometimes called a minority interest.</td>
</tr>
<tr>
<td>Non-revolving debt arrangements (term debt)</td>
<td>Unlike a line of credit (or revolving debt arrangement), a non-revolving debt arrangement (or term debt) is a credit agreement that provides the borrower with a fixed repayment plan within which further credit is not extended as payments are made.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Option price, put price, or call price</td>
<td>The price (or cost) of an option is an amount of money known as the premium. An option buyer pays this premium to an option seller in exchange for the right granted by the option (i.e., the choice to exercise the option or allow it to expire). The option price is made up of two components: intrinsic value and time value. The intrinsic value for a call option is equal to the underlying price minus the strike price; the intrinsic value for a put option is equal to the strike price minus the underlying price. An option's time value is equal to its premium minus its intrinsic value. As a general rule, the more time that remains until expiration, the greater the time value of the option.</td>
</tr>
<tr>
<td>Out of the money</td>
<td>The opposite of in the money (see definition above). A call option with a strike price that is higher than the market price of the underlying asset, or a put option with a strike price that is lower than the market price of the underlying asset, is said to be out of the money. An out of the money option has no intrinsic value; however, it may still possess time value.</td>
</tr>
<tr>
<td>Participation right</td>
<td>Contractual rights of security holders to receive dividends or returns from the security issuer’s profits, cash flows, or returns on investment.</td>
</tr>
<tr>
<td>Payment in kind</td>
<td>Bonds in which the issuer has the option at each interest payment date of making interest payments in cash or in additional debt securities. Those additional debt securities are referred to as baby or bunny bonds. Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds (parent payment-in-kind bonds). Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.</td>
</tr>
<tr>
<td>Permanent equity</td>
<td>Permanent equity refers to the stockholder’s equity section of the balance sheet. It is the sum of capital stock, additional paid-in capital, and retained earnings.</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>An equity security that has preferential rights compared to common stock.</td>
</tr>
<tr>
<td>Premium</td>
<td>The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity.</td>
</tr>
<tr>
<td>Prepayment option</td>
<td>A call option embedded in a debt.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>
| Put option                        | If a company *buys* a put option on its own equity, the put option provides the company with the right, but not the obligation, to sell a specified quantity of its shares to the counterparty (put option seller) to the contract at a fixed price for a given period.  
   If a company *sells* a put option on its own equity, the put option obligates the company to buy a specified quantity of its shares from the counterparty (put option buyer) to the contract at a fixed price for a given period.  
   A put option embedded in a debt instrument provides the investor (lender) with the right to demand repayment prior to the stated maturity date. |
| Puttable                          | An instrument is puttable if the holder or investor has the right to sell the instrument back to the issuing party at a certain price.                                                                                                                                                                                                 |
| Reacquisition price of debt       | The amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities.                                                                                   |
| Straight-line method              | A method of computing amortization by spreading the cost of an asset equally over its lifetime.                                                                                                                                                                                                                                         |
| Time value                        | A core principle of finance based on the premise that money available at the present time is worth more than the same amount in the future due to its potential earning capacity (i.e., the potential to earn interest).  
   In the case of options, the time value is the portion of an option’s premium that is attributable to both the volatility of the underlying security and the amount of time remaining until the expiration of the option. An option’s premium is comprised of two components: its intrinsic value and its time value. The intrinsic value is the difference between the price of the underlying (for example, the underlying stock or commodity) and the strike price of the option. Any premium that is in excess of the option’s intrinsic value is referred to as its time value. |
<p>| Treasury stock                    | Treasury stock is created when a reporting entity reacquires its own common stock. These shares don’t pay dividends and have no voting rights. After reacquiring shares, a reporting entity may either retire them or hold them in the treasury for reissue. If not retired, such shares are referred to as treasury stock. Treasury stock is essentially the same as unissued capital stock. |
| Troubled debt restructuring        | A 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.                                                                                     |</p>
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units structures</td>
<td>Bundled instruments that typically involve debt securities that are issued along with a share issuance derivative contract, such as a detachable warrant or a variable share forward delivery agreement.</td>
</tr>
<tr>
<td>Variable share forward delivery agreement</td>
<td>In a variable share forward delivery agreement, the issuer sells shares of its common stock for forward delivery at a stated price with the number of shares to be issued dependent upon the then current market price of the common stock, subject to a minimum and maximum number of shares. Typically, the investor is required to pay the stated price to the issuer at the settlement date. Economically, a variable share forward delivery agreement is a combination of a written call option and a purchased put option, each with different strike prices. Refer to FG section 9.3.2 for further detail, including an illustrative example, with regard to variable share forward delivery agreements.</td>
</tr>
<tr>
<td>Warrant</td>
<td>A written call option on the issuer’s own common or preferred equity shares.</td>
</tr>
</tbody>
</table>
Appendix D: Summary of significant changes

The following is a summary of the significant changes made when the guide was fully updated in July 2017 and revisions to select topics completed in December 2018.

Revisions made in December 2018

FG 5, Equity-linked instruments model

- Example 5-2, Example 5-3 and Example 5-4, which were previously published in In depth 2015-01, were incorporated into FG 5.4.1.1.

Revisions made in July 2017

FG 1, Debt

- Updates were made throughout FG 1 to reflect the guidance in ASU 2015-03, Simplifying the Presentation of Debt Issuance Costs.

- FG 1.2.2.1 was updated to cite SEC guidance as the basis for the accounting treatment discussed, but the accounting treatment is not affected.

- FG 1.2.4, Debt issued under a delayed delivery agreement was deleted and replaced with FG 1.2.4, Delayed drawn debt.

- The guidance in FG 1.3 regarding line of credit and revolving-debt fees was updated to reflect the June 2015 SEC staff announcement regarding the application of ASU 2015-03 to these instruments.

- FG 1.6.1 was updated for the issuance of ASU 2016-06, Contingent Put and Call Options in Debt Instruments.

FG 2, Guarantees and joint and several debt obligations

- FG 2.4.1, Indemnification of officers and directors was added.

- FG 2.6.2.1, Initial measurement of the contingent component of a guarantee within the scope of ASC 326, and FG 2.7.1, Subsequent measurement for a guarantee within the scope of ASC 326, were added to reflect the guidance in ASC 326, Financial Instruments – Credit Losses.

FG 3, Debt modification and extinguishment

- The guidance on debt modifications with a change in principal in FG 3.4.5 has been updated.
Appendix D: Summary of significant changes

- Portions of Example 3-7 in FG 3.6, which illustrate the accounting for unamortized costs and third-party costs when a loan is modified, were revised to reflect the change in guidance in FG 3.4.5.

- FG 3.8, Debt defeasance, was rewritten to improve clarity.

FG 4, Common stock and dividends

- The guidance on preferred stock was moved from FG 4 to FG 7.

- The guidance on common stock and dividends was moved from FG 5 to FG 4.

- Added guidance to FG 4.5, Other transactions with shareholders.

FG 5, Equity-linked instruments model

- The guidance on common stock and dividends was moved from FG 5 to FG 4.

- The guidance on the equity-linked instruments model was moved from FG 7 to FG 5.

- FG 5.4.1.1, Determining the nature of the host contract for an equity-linked preferred share, was updated for the issuance of ASU 2014-06, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity.

- FG 5.5 and FG 5.6 were updated for the issuance of ASU 2017-11, (Part I) Accounting for Certain Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception.

FG 6, Convertible debt

- The guidance on share repurchase and treasury stock was moved from FG 6 to FG 9.

- The guidance on convertible debt was moved from FG 9 to FG 6.

FG 7, Preferred stock

- The guidance on the equity-linked instruments model was moved from FG 7 to FG 5.

- The guidance on convertible preferred stock was moved from FG 9 to FG 7.

- FG 7.3 was updated to include consideration of convertible preferred stock. It was also updated to clarify the application of the guidance in ASC 480 to preferred stock.

- FG 7.3.2 was updated to include the guidance in ASU 2014-06, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity.
□ FG 7.3.2.2 was updated to include guidance on contingently adjusting conversion prices. The guidance on contingent BCFs, including Example 7-2, was also updated to clarify the guidance.

□ The guidance in FG 7.3.4.1 regarding ordinary liquidation vs. deemed liquidation events was updated to clarify the guidance.

□ Guidance on the subsequent measurement of mandatorily redeemable preferred stock classified as mezzanine equity was added in FG 7.4.3.2.

□ The guidance on determining whether a preferred stock modification or exchange should be accounted for as a modification or extinguishment and the accounting for preferred stock modifications in FG 7.8 was updated.

FG 8, Accounting for equity-linked instruments

□ FG 8.2.2.3, Penny warrants, was added.

FG 9, Share repurchase and treasury stock

□ The guidance on convertible debt was moved from FG 9 to FG 6; the guidance on convertible preferred stock was moved from FG 9 to FG 7.

□ The guidance on share repurchase and treasury stock was moved from FG 6 to FG 9.
About PwC’s National Accounting Services Group

The Accounting Services Group (ASG) within the Firm’s National Quality Organization leads the development of Firm perspectives and points of view used to inform the capital markets, regulators, and policy makers. ASG assesses and communicates the implications of technical and professional developments on the profession, clients, investors, and policy makers. The team consults on complex accounting and financial reporting matters and works with clients to resolve issues raised in SEC comment letters. They work with the standard setting and regulatory processes through communications with the FASB, SEC, IASB and others. The team provides market services such as quarterly technical webcasts and external technical trainings, including our alumni events. The team is also responsible for sharing their expert knowledge on topics through internal and external presentations and by authoring various PwC publications.

In addition to working with the US market, the ASG team has a large global team that is involved in the development of IFRS.

The team of experienced Partners, Directors, and Senior Managers helps develop talking points, perspectives, and presentations for when Senior Leadership interacts with the media, policy makers, academia, regulators, etc.

About PwC

At PwC, our purpose is to build trust in society and solve important problems. PwC is a network of firms in 157 countries with more than 223,000 people who are committed to delivering quality in assurance, advisory, and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com/US.

“PwC” is the brand under which member firms of PricewaterhouseCoopers International Limited (PwCIL) operate and provide services. Together, these firms form the PwC network. Each firm in the network is a separate legal entity and does not act as agent of PwCIL or any other member firm. PwCIL does not provide any services to clients. PwCIL is not responsible or liable for the acts or omissions of any of its member firms nor can it control the exercise of their professional judgment or bind them in any way.