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Technical Line

FASB — final guidance

A closer look at the new guidance on distinguishing liabilities from equity and EPS

In this issue:

What you need to know

- The new guidance simplifies an issuer's accounting for convertible instruments by eliminating two of the three models in ASC 470-20 that require separate accounting for embedded conversion features. As a result, more convertible instruments will be reported as single units of account.
- The guidance simplifies the settlement assessment that issuers perform to determine whether a contract in their own equity qualifies for equity classification. As a result, more freestanding contracts will qualify for equity classification and more embedded features will qualify for the derivative scope exception.
- The guidance requires entities to use the if-converted method for all convertible instruments and generally requires them to include the effect of share settlement for instruments that may be settled in cash or shares.
- For PBEs other than smaller reporting companies as defined by the SEC, the guidance is effective for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein. Early adoption is permitted in fiscal years beginning after 15 December 2020.

Overview

The new guidance[1] issued by the Financial Accounting Standards Board (FASB or Board) simplifies an issuer's accounting for convertible instruments and its application of the equity classification guidance.

Building a better working world

The FASB issued Accounting Standards Update (ASU) 2020-06 in response to feedback it received from preparers, auditors and users of financial statements that the legacy guidance is unnecessarily complex and often results in conclusions based on form rather than substance. Those models were developed over time to address instruments with new features, and they lack a common principle.

Under the new guidance, only conversion features that are accounted for as derivatives in accordance with Accounting Standards Codification (ASC) 815-15[2] or under the substantial premium model in ASC 470-20[3] will require separate accounting. As a result, issuers are expected to account for more convertible debt and convertible preferred shares as single units of account on the balance sheet under the traditional debt and equity models, respectively.

Eliminating some of the requirements for equity classification in ASC 815-40,[4] meanwhile, will allow more contracts in an entity's own equity to qualify for equity classification and more embedded features to qualify for the derivative scope exception.

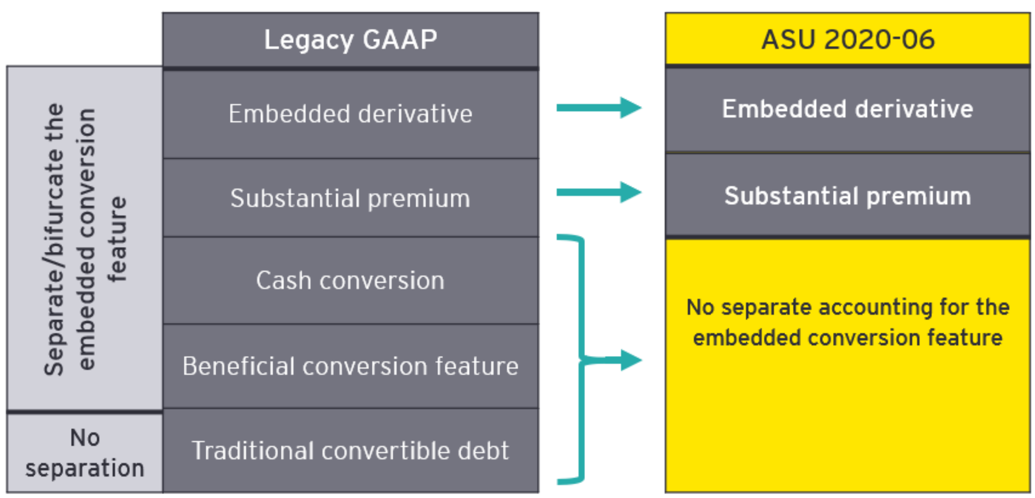
The new guidance requires issuers to provide enhanced disclosures about convertible instruments and contracts in their own equity, including information about events, conditions and circumstances that can affect how users assess the amount or timing of their future cash flows. It also modifies the if-converted method of calculating diluted earnings per share (EPS) and requires its use for all convertible instruments. It also generally requires entities to include the effect of share settlement for instruments that may be settled in cash or shares.

The new guidance simplifies an issuer's accounting for convertible instruments.

Key amendments

Convertible instruments

The new guidance eliminates the cash conversion and beneficial conversion feature models in ASC 470-20 that require separate accounting for conversion features, as shown in the illustration below. As a result, an issuer will account for a convertible instrument as a single unit of account, unless the conversion feature is a derivative that must be bifurcated from the host contract in accordance with ASC 815-15 or the substantial premium model in ASC 470-20 applies. The bifurcation analysis under ASC 815-15 will still be performed before the substantial premium model is considered.



The new guidance is intended to make the accounting for convertible instruments less complex and to provide more useful information to users of the financial statements. In issuing the ASU, the FASB said it received feedback from users who generally analyze convertible instruments as a single unit and are more interested in how much interest issuers actually pay on their debt than the interest expense issuers report when they account for conversion features under the beneficial conversion feature and cash conversion models. Those models require issuers to recognize a debt discount that is amortized to interest expense.

Under the new guidance, entities that had been applying the beneficial conversion feature and cash conversion models will report less interest expense since they will account for more instruments as traditional debt. Issuers that are required to separately account for a conversion feature under the substantial premium model will record the premium in additional paid-in capital.

Issuers will still need to exercise judgment to apply the substantial premium model, which hasn't been applied often in practice. The guidance does not define a substantial premium, so issuers will need to evaluate the facts and circumstances. That evaluation may be complicated if an instrument contains certain other features that are accounted for separately as derivatives.

How we see it

We generally believe a premium that is approximately 10% or more of the principal amount of a note should be considered substantial. But entities may determine that a smaller premium is substantial, based on the facts and circumstances. For example, a premium of less than 10% might be substantial if an entity would recognize negative interest expense for convertible debt under the traditional model, which requires amortization of premiums. This could happen if the premium amortization results in negative interest expense.

Further analysis will also be required when a convertible debt instrument has other features that might have resulted in the premium. We generally believe that, if there are any embedded derivatives that are bifurcated and could be separately settled before or at conversion (e.g., interest make-whole features), an issuer should adjust the proceeds it uses to determine whether a substantial premium exists. That is, the issuer should reduce the proceeds it initially allocated to the convertible debt by the fair value of the bifurcated embedded derivative and use the lower amount to determine whether the conversion feature resulted in a substantial premium.

The new guidance also makes it less likely that issuers will recognize gains or losses upon conversion of debt. These gains and losses generally resulted from applying the legacy derecognition guidance in the beneficial conversion feature and cash conversion models.

Under the new guidance, the conversion of debt that is accounted for as a liability in its entirety will not result in any gain or loss if the conversion feature is exercised pursuant to the original conversion terms. If those terms allowed the issuer to include cash or other assets as part of the settlement of the conversion feature, the issuer will first reduce the carrying amount of the convertible debt, including any unamortized premium, discount or issuance costs, by the value of the cash or other assets transferred and then recognize the remaining carrying value of the debt in the capital accounts.

The new guidance will also significantly change an issuer's accounting for equity-classified convertible preferred stock. These instruments will be accounted for as single units of account in equity unless the conversion feature needs to be bifurcated under ASC 815. That is, issuers will no longer consider whether the conversion feature should be separated under the guidance in ASC 470, which has resulted in separate accounting for in-the-money conversion features in equity-classified preferred stock under the beneficial conversion feature model in the legacy guidance.

Issuers of convertible preferred shares that are classified as liabilities under ASC 480-10,[5] by contrast, will continue to apply the guidance in ASC 470-20, meaning they will evaluate whether the conversion feature needs to be accounted for separately under the substantial premium model.

The new guidance does not apply to convertible instruments that are issued as awards to a grantee in exchange for goods or services and are in the scope of ASC 718,[6] unless the instrument is modified and no longer subject to ASC 718.

Illustration 1 – Recognition, measurement and derecognition of convertible debt

Company A, a privately held corporation, issued convertible debt on 1 January 20X1 with a par amount of $100 million, an annual coupon rate of 2% and a maturity in 10 years. The conversion feature is exercisable anytime and can be settled in cash, common stock (par value of $1 per share) or any combination of the two at the option of Company A. Assume that the conversion feature meets the equity derivative scope exception in ASC 815-40, and there are no other embedded features in the convertible debt. The conversion price is $100, and the fair value of each underlying share is $104 at issuance. Company A issued the convertible debt to Investor X for proceeds of $104 million in cash.

Company A first determines whether the conversion option should be bifurcated and accounted for as a derivative in accordance with ASC 815-15. Because the conversion feature meets the derivative scope exception, the embedded conversion feature is not bifurcated from the debt host.

Company A then determines whether the debt should be accounted for under the substantial premium model. Company A does not view the 4% premium over the par value to be substantial and does not apply the model.

Therefore, the instrument is accounted for as a liability without any bifurcation or separation of the embedded conversion feature. Company A initially records the following entry:

Dr. Cash	$ 104 million	
Cr. Debt		$ 104 million

From Year 20X1 to Year 20X5, Company A records the following entry each year to amortize the premium and record interest expense and the cash disbursement:

Dr. Debt (premium)	$ 0.4 million*	
Dr. Interest expense	$ 1.6 million	
Cr. Cash		$ 2 million

* For simplicity, assume that the straight-line amortization method approximates the effective interest method.

At the end of Year 20X5, Investor X exercises the conversion feature pursuant to the original conversion terms. Company A elects to settle the debt by paying $50 million in cash and issuing 500,000 shares of its common stock. The following entries will be recorded:

Dr. Debt	$ 102 million	
Cr. Cash		$ 50.0 million
Cr. Common stock (par)		$ 0.5 million
Cr. Additional paid-in capital		$ 51.5 million

Contracts in an entity's own equity

The ASU also simplifies the settlement assessment that entities are required to perform to determine whether a contract in their own equity qualifies for equity classification by removing certain conditions in ASC 815-40-25.

As a result, more freestanding contracts are expected to qualify for equity classification and more embedded features are expected to qualify for the derivative scope exception, which also requires a contract to be indexed to the entity's own equity under ASC 815-40-15.

To determine whether a contract meets the settlement criterion for equity classification, entities will no longer have to assess whether a contract permits settlement in unregistered shares. Instead, they must analyze whether the contract explicitly requires them to settle the contract in cash when registered shares are unavailable, and only contracts that require settlement in cash in this situation will be precluded from being classified as equity. Contracts that permit settlement in unregistered shares or are silent about how they will be settled when registered shares are unavailable can be classified as equity.

Further, entities will no longer have to assess whether an equity contract requires any collateral or provides the holder with rights that rank higher than shareholder rights in bankruptcy.

The new guidance simplifies the settlement assessment of contracts in an entity's own equity.

How we see it

Eliminating the requirement that contracts legally permit settlement in unregistered shares to be classified as equity means entities will no longer have to make a determination that might require a legal analysis under the securities laws. We believe this change will reduce the complexity of evaluating these contracts.

The amendments also require freestanding equity contracts that do not meet the definition of a derivative (e.g., physically settled warrants issued by private companies) to be subsequently measured at fair value through earnings if they are not indexed to an entity's own equity under ASC 815-40-15. US GAAP does not currently provide subsequent measurement guidance for these instruments, and some entities carry them at cost. Entities that do that can expect earnings to be more volatile when they adopt the new guidance.

Illustration 2 – Warrants

Company B, a privately held company, issues warrants that require settlement in Company B's common stock that is not readily convertible to cash. Therefore, the warrants are not derivatives because they do not meet the net settlement criterion in ASC 815. The warrants' exercise price is reduced by $1 if Company B's revenue is less than $100 million as of the first anniversary date of issuance.

The potential adjustment to the warrants' strike price precludes the warrants from equity classification under ASC 815-40-15. Under the legacy guidance, these warrants could be carried at cost because there is no subsequent measurement guidance for non-derivative equity-linked instruments that are not indexed to equity in accordance with ASC 815-40-15. Under the new guidance, such warrants are subsequently measured at fair value through earnings.

Other amendments make clarifications that include:

- Entities exclude penalty payments from the equity classification assessment under ASC 815-40-25 because they do not result in settlement of an equity contract.

- The scope of the reassessment guidance in ASC 815-40-35 applies to both freestanding instruments and embedded features. While this clarification provides new reassessment guidance for embedded features, the FASB said it is not expected to significantly change practice because the reassessment guidance in ASC 815-40-35 has been applied to both freestanding instruments and embedded features in practice.

Earnings per share

The ASU amends ASC 260[7] to simplify and improve the consistency of the diluted EPS calculation. It also requires entities to assume maximum potential dilution.

If-converted method

The guidance requires entities to use the if-converted method to calculate diluted EPS for all convertible instruments. Under legacy GAAP, the treasury stock method is used to calculate the dilutive effect on EPS for some of them (e.g., convertible debt where, upon conversion, the issuer must pay the principal of the debt in cash but may settle the conversion premium in cash or shares). The guidance also modifies the if-converted method so that interest charges on convertible debt for which the principal is required to be paid in cash would not be added back to the numerator.

The if-converted method will continue to use the share price at the beginning of the period in the calculation, unless the number of additional shares is variable, such as when (1) the exercise price may change based on an entity's share price or (2) changes in the entity's share price may affect the number of shares that may be used to settle a financial instrument. In these cases, entities will use the average share price to calculate the number of shares included in the denominator. This amendment regarding the use of the average share price when the number of additional shares is variable is intended to reduce diversity in practice and is consistent with the existing requirements of the treasury stock method.

Instruments that may be settled in cash or shares

For instruments that may be settled in cash or shares and aren't liability-classified share-based payment awards, the amendments to ASC 260 require entities to include the effect of potential share settlement (if the effect is more dilutive), regardless of whether the entity or the holder can choose between cash and share settlement, or the entity has a history or policy of cash settlement.

As a result, maximum potential dilution will be reflected in diluted EPS. Entities may report lower diluted EPS than they would under the legacy guidance, and the effect on EPS may not reflect an entity's expectations before settlement (i.e., if the entity intends to settle the instrument in cash). The guidance in ASC 260 allowing an entity to overcome the presumption of share settlement in some cases will continue to apply to certain liability-classified share-based payment awards.

Under legacy GAAP, how a contract that can be settled in cash or shares should be reflected in the computation of diluted EPS depends on which party controls the means of settlement and the facts available each period. This determination can result in additional shares being included in the denominator as well as adjustments to the numerator of the diluted EPS calculation. Numerator adjustments arise when, for example, the presumption for EPS purposes is stock settlement but the instrument is classified as an asset or liability for accounting purposes. Similar adjustments may continue to be required after the adoption of the ASU, depending on how the instrument is classified for accounting purposes (e.g., if it is classified as a liability).

Equity-classified convertible preferred stock with a down round feature

The amendments also include equity-classified convertible preferred stock that has a down round feature in the scope of the recognition and measurement guidance in ASC 260 because, as discussed above, these instruments will no longer be evaluated under the legacy beneficial conversion feature guidance.

Down round features are designed to protect the holder from declines in the issuer's share price. They reduce the exercise price if the entity sells stock for a lower price or issues an equity-linked instrument with a lower exercise price in the future, typically to the new issuance or exercise price. They also can reduce the exercise price based on a formula or set a floor below which the exercise price cannot fall.

Under ASC 260, the effect of a down round feature is recognized when it is triggered (i.e., when the exercise price is reduced). ASC 260 also provides guidance on how to measure the amount to be recognized.[8] That amount is treated as a dividend and a reduction to income available to common stockholders in the basic EPS calculation. However, we believe that, when an entity calculates diluted EPS, this amount should be added back to income available to common stockholders.

Disclosures

Entities are required to disclose information about events, conditions and circumstances that can affect how users assess the amount or timing of settlement.

Convertible instruments

The new guidance requires enhanced disclosures that are intended to provide users with information about the terms and features of convertible debt and preferred stock, how the convertible instruments are reported in an entity's income statement and balance sheet, and other events, conditions and circumstances that can affect how users assess the amount or timing of an entity's future cash flows.

Entities will be required to disclose the following new information, among other things, for convertible debt under ASC 470-20-50 and convertible preferred stock under ASC 505-10-50:[9]

- Pertinent rights and privileges of each convertible instrument, such as principal amount, coupon rates, conversion prices, conversion dates, terms that may alter conversion prices and the number of shares to be issued, which party controls the conversion rights, and settlement methods (i.e., cash, shares or a combination of the two)
- Additional information about contingently convertible instruments, such as events or changes in circumstances that would cause the contingency to be met, and the nature of the contingencies
- Changes to conversion or exercise prices that occurred during the reporting period (excluding changes resulting from the standard antidilution provisions) and events or changes in conditions that occurred during the reporting period that cause conversion contingencies to be met, and the number of shares issued upon conversion
- Information about convertible debt that includes the:
  - Unamortized premium, discount or issuance costs and net carrying value as of each reporting date
  - Effective interest rate and interest expense recognized for each reporting period
  - Premium recorded as paid-in capital when the instrument is accounted for under the substantial premium model
  - Fair value of convertible instruments at the individual instrument level rather than in the aggregate for public business entities (PBEs)

- Information about convertible preferred stock that includes liquidation preferences, unusual voting rights and the amount of dividends declared for each reporting period

Contracts in an entity's own equity

The amendments to the disclosure requirements for freestanding instruments also state an objective of providing users with information about the terms and features of contracts in an entity's own equity, how the instruments are reported in an entity's income statement and balance sheet, and events, conditions and circumstances that can affect how users assess the amount or timing of an entity's future cash flows.

These amendments also require the disclosure of:

- Who controls settlement alternatives and the description thereof
- Information for each settlement alternative, including:
  - The amount to be paid or the number of shares to be issued and their fair value in accordance with the contractual provisions, if the settlement were to occur at the reporting date
  - How changes in the fair value of the issuer's equity shares affect those settlement amounts

Effective date and transition

The ASU is effective for fiscal years beginning after 15 December 2021, and interim periods therein for PBEs that are not smaller reporting companies, as defined by the Securities and Exchange Commission (SEC), as of 5 August 2020. For all other entities, it is effective for fiscal years beginning after 15 December 2023, and interim periods therein.

Early adoption is permitted for all entities for fiscal years beginning after 15 December 2020, but an entity must adopt the guidance as of the beginning of a fiscal year.

Entities that have not yet adopted the guidance in ASU 2017-11[10] may apply the recognition and measurement guidance in ASU 2020-06 to convertible securities with down round features in interim or annual financial statements for fiscal years beginning after 15 December 2019 that have not yet been issued or made available for issuance.

Transition

The ASU allows entities to use either a modified retrospective or full retrospective transition method. Under the modified retrospective approach, entities will apply the guidance to all financial instruments that are outstanding as of the beginning of the year of adoption, with the cumulative effect recognized as an adjustment to the opening balance of retained earnings. Under the full retrospective method, they will apply it to all financial instruments that are outstanding as of the beginning of the first comparative reporting period for each prior reporting period presented in accordance with the guidance on accounting changes in ASC 250-10-45-5 through 45-10.[11]

When they adopt the new guidance, entities will need to recombine instruments that they previously separated into two units of account if separation is no longer required. That is, a conversion option that was previously accounted for under the cash conversion model or beneficial conversion feature model will be recombined into a single instrument that is classified as a liability for convertible debt (if separation isn't required under the substantial premium model) or as equity for equity-classified preferred stock.

To compute the transition adjustment for a convertible instrument under both the modified retrospective and full retrospective methods, entities need to recompute the basis of that instrument at transition (i.e., the beginning of year of adoption for the modified retrospective method or the beginning of earliest year presented for the full retrospective method) as if the conversion option had not been separated. This requires an entity to determine the amortized cost of the instrument at contact inception and then recalculate the amortization of the discount (or premium) under the effective interest method using the recalculated effective interest rate.

The adjustment to retained earnings will be the difference between the sum of the carrying values of the debt or preferred stock and the conversion feature immediately before transition and the revised amortized cost of the combined convertible instrument under the substantial premium or traditional debt model as of the transition date. Entities will also need to consider the income tax accounting effects when determining the retained earnings adjustment.

How we see it

Because the substantial premium model will continue to exist after entities adopt the new guidance, they will be required to assess whether that model applies to any outstanding convertible debt instruments as of the transition date. That's because the substantial premium model was only considered under legacy guidance if the conversion feature was not already separated pursuant to the cash conversion or beneficial conversion feature guidance. With the elimination of those two models, any conversion features previously separated pursuant to those models must be recombined with the debt host as if they had not been separated. That may create a premium that is viewed as substantial.

Entities must also consider any freestanding contracts in an entity's own equity issued with the convertible instrument that were required to be subsequently measured at fair value under legacy guidance but are not required to be subsequently measured that way under the ASU, or vice versa. That's because this could affect the amount of proceeds that was originally allocated to the convertible instrument when it was initially recognized.

When entities adopt the new guidance, they need to consider the potential income tax accounting effects.

Income tax accounting considerations at transition

Entities with instruments that are recombined at transition (i.e., instruments with beneficial conversion features or cash conversion options) need to consider the tax accounting consequences of the adoption. Recombining previously separated instruments at transition may change the difference between the book and tax bases of the instruments. As a result, entities may need to adjust deferred tax liabilities related to these instruments.

Entities that apply the full retrospective method of adoption need to adjust each previously reported tax provision and deferred tax amounts for purposes of recasting the financial statements of prior reporting periods.

Changes to valuation allowances

When adopting the new guidance, entities may need to adjust deferred tax liabilities or reevaluate expectations about the timing of future taxable income, which may affect their judgments regarding the realizability of deferred tax assets.

For example, an entity that recorded a deferred tax liability related to an instrument with a beneficial conversion feature may have considered the eventual reversal of the related deferred tax liability as a source of future taxable income when evaluating the realizability of its deferred tax assets. If the amount of the deferred tax liability decreases or is eliminated upon adoption of the ASU, the entity may conclude that a valuation allowance should be recorded (or an existing valuation allowance should be increased). Therefore, the entity would record the valuation allowance (or the increase of an existing valuation allowance) as part of the cumulative effect adjustment. Changes in the valuation allowance that are not a direct result of adopting the standard are recorded as a component of income tax expense from continuing operations. Careful consideration of the facts and circumstances is necessary to determine whether the change in valuation allowance is a direct effect of adopting the ASU.

The example below illustrates the transition adjustments, including adjustments for income tax effects, that an entity would record for convertible debt issued a year before it adopts the new guidance.

Illustration 3 – Transition adjustments

On 1 January 20X0, a year before it adopts ASU 2020-06, Company C issues convertible debt with a par amount of $1,000,000, an annual coupon rate of 1% and a maturity in two years. The conversion feature in the convertible debt is exercisable anytime and can only be settled in the company's common stock, which is not publicly traded (i.e., it is not readily convertible into cash). Company C received $900,000 in proceeds. The stated conversion price is $10 per share, and the fair value of each underlying share is $10 at the commitment date.[a]

The effective conversion price is $9 per share ($900,000 proceeds/100,000 shares) and results in a beneficial conversion option with an intrinsic value of $100,000 [100,000 shares × ($10 − $9)].

Because of the additional discount created under the beneficial conversion feature guidance, the debt discount is $200,000 on 1 January 20X0. The company's effective tax rate is 25%, and it does not have a valuation allowance recorded on its deferred tax assets. The journal entry to record the initial issuance is:

Dr. Cash	$	900,000		
Dr. Debt discount — beneficial conversion option	$	100,000		
Dr. Debt discount — issuance	$	100,000		
Cr. Convertible debt			$	1,000,000
Cr. Additional paid-in capital			$	100,000

The issuance of the convertible debt with a beneficial conversion feature results in a $100,000 difference between the book basis of the instrument (calculated by deducting both the $100,000 conversion option and the $100,000 discount at issuance from the par value of $1,000,000) and the tax basis ($900,000). (For purpose of this illustration, the tax basis of the debt instrument includes the original issue discount.) The journal entry to record the deferred tax consequence upon issuance of the instrument is as follows:

Dr. Additional paid-in capital	$	25,000		
Cr. Deferred tax liability			$	25,000

On 31 December 20x0, Company C records the following entries (assume that the straight-line method approximates the effective interest method):

Dr. Interest expense	$	110,000		
Cr. Debt discount — beneficial conversion option			$	50,000
Cr. Debt discount — issuance			$	50,000
Cr. Cash — annual coupon of 1%			$	10,000

Company C records the following entry to recognize the income tax effects related to the amortization of the debt discount-issuance and debt discount-beneficial conversion option:

Dr. Current income tax payable (($110,000 – $50,000) *.25)	$ 15,000	
Dr. Deferred tax liability	$ 12,500	
Cr. Current income tax benefit		$ 15,000
Cr. Deferred income tax benefit		$ 12,500

As of 31 December 20X0, the carrying value of the convertible debt is $900,000 (the initial carrying value of $800,000 plus the amortization of the debt discounts of $100,000 as of the end of the period).

On 1 January 20X1, Company C adopts ASU 2020-06 and elects the modified retrospective approach. Because the beneficial conversion feature is not required to be separated and the debt was issued at a discount, the conversion feature should not be bifurcated under ASC 815 or accounted for under the substantial premium model. Company C computes the transition adjustment as follows:

Under ASU 2020-06, the convertible debt would have been accounted for as a single unit of account. The carrying value as of 31 December 20x0 would have been $950,000 ($900,000 + the amortization of the $100,000 discount over the two-year period, or $50,000). To adjust the carrying value of convertible debt from $900,000 to $950,000, Company C records the following transition entries to the beginning retained earnings and additional paid-in capital as of 1 January 20x1:

Dr. Additional paid-in capital	$ 100,000	
Cr. Debt discount — beneficial conversion option		$ 50,000
Cr. Retained earnings		$ 50,000

Company C also records the following transition entry to reflect the tax effects of adopting the ASU as of 1 January 20X1:

Dr. Deferred tax liability	$ 12,500	
Dr. Retained earnings	$ 12,500	
Cr. Additional paid-capital		$ 25,000

Company C concluded that the adoption of the ASU did not change its prior valuation allowance conclusions. If the elimination of the deferred tax liability required the company to increase its valuation allowance solely due to the adoption of the ASU, the company would have recorded the increase in the valuation allowance as part of the transition adjustment.

[a] Because the net settlement criterion under ASC 815-10 is not met, the conversion feature is not bifurcated under ASC 815. Also, because the conversion feature can only be settled with shares, the cash conversion guidance is not applicable.

Optional election

An entity also may irrevocably elect the fair value option in accordance with ASC 825-10[12] for any liability-classified convertible securities. For any convertible securities for which the fair value option is elected at transition, the difference between their carrying amount and their fair value will be recorded as a cumulative-effect adjustment to opening retained earnings as of the beginning of the period of adoption.

Transition disclosures

When they adopt the new guidance, entities must disclose the following:

- The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle
- The method of applying the change
- The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the ASU is initially applied
- The effect of the change on per-share amounts for the period of adoption if they present EPS

Under the full retrospective method, entities also need to disclose the effect of the change on income from continuing operations, net income, any other affected financial statement line item and per-share amounts for the current period and any prior periods that are adjusted.

For interim reporting purposes, entities are required to provide the applicable transition disclosures in all interim financial statements issued in the year of adoption.

What's next

In the second phase of its project to simplify the issuer's accounting for contracts in an entity's own equity, the FASB plans to simplify and align the indexation models in ASC 480 and ASC 815-40 that an entity uses to evaluate financial instruments with characteristics of equity. Companies that would be affected should monitor developments.

Endnotes:

1 ASU 2020-06, *Debt — Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40), Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*.

2 ASC 815-15, *Derivatives and Hedging — Embedded Derivatives.*

3 ASC 470-20, *Debt — Debt with Conversion and Other Options.*

4 ASC 815-40, *Derivatives and Hedging — Contracts in Entity's Own Equity*.

5 ASC 480-10, *Distinguishing Liabilities from Equity — Overall*.

6 ASC 718, *Compensation — Stock Compensation*.

7 ASC 260, *Earnings Per Share*.

8 ASC 260-10-30-1, *Earnings Per Share — Overall — Initial Measurement.*

9 ASC 505-10, *Equity — Overall*.

10 ASU 2017-11, *Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features*.

11 ASC 250-10-45, *Accounting Changes and Error Corrections — Overall — Other Presentation Matters*.

12 ASC 825-10, *Financial Instruments — Overall*.