You Might Want to Consider Adopting ASU 2020-06 Early

by

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Often, start-up, emerging, and other companies with high expectations for growth use convertible instruments (e.g., debt or preferred stock) to raise funds for expansion or capital investments. In order to reduce funding costs, these instruments are issued with embedded conversion features that allow the holder to redeem the instruments for equity securities at a later date.

The current accounting for convertible instruments is complex and often requires certain embedded features to be recorded separately from the host instrument.

In August, the FASB issued ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity. The purpose of ASU 2020-06 was to simplify the accounting for convertible instruments. The two most significant changes are:

1. Embedded conversion features no longer are separated from the host contract for convertible instruments with conversion features provided that:
    a. They are not required to be accounted for as derivatives under ASC 815, Derivatives and Hedging, (i.e., not clearly and closely related to the host instrument), or
    b. They do not result in substantial premiums accounted for as paid-in capital.

2. More instruments will be able to qualify for the scope exception under ASC 815 as an "entity's own equity" by removing three of the seven requisite conditions from the settlement guidance:
    a. Settlement permitted in unregistered shares,
    b. No collateral required, and
    c. No counterparty ranks higher than shareholder rights.

As a result, traditional conversion features (e.g., beneficial conversion features and cash conversion features) no longer will be recorded separately from the host instrument. Also, more contingent conversion features (e.g., upon a change in control or new round of financing) will qualify for the ASC 815 scope exception, which means that they will not need to be recorded separately as derivative instruments (at fair value).

In addition, ASU 2020-06 streamlines the EPS calculation for convertible instruments (e.g., by requiring the use of the if-converted method) and requires a few additional disclosures (e.g., identifying which party controls the conversion rights and events that have triggered conversion features during the reporting period).

ASU 2020-06 is effective for public companies (except smaller reporting companies) for fiscal years beginning after December 15, 2021 (i.e., January 2022 for calendar fiscal years) and fiscal years beginning after December 15, 2023 for all other entities (i.e., January 2024 for calendar fiscal years). However, the ASU can be adopted early starting in fiscal years beginning after December 15, 2020 (i.e., January 2021 for calendar fiscal years).

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Either a modified retrospective or full retrospective method of adoption can be applied upon adoption. Under the modified retrospective method, the new guidance would be applied to transactions outstanding as of the beginning of the fiscal year of adoption. Transactions that were settled (or expired) prior to adoption would be unaffected. The cumulative effect of the change would be recognized as an adjustment to beginning retained earnings. Under the full retrospective method of transition, the cumulative effect of the change would be recognized as an adjustment to beginning retained earnings of the earliest period presented.

Because of the simplified accounting for convertible instruments, companies that have issued convertible instruments with traditional conversion features will want to carefully consider whether early adoption of ASU 2020-06 starting next year makes sense. As the accounting for such instruments will be less burdensome under the new standard, there would seem to be little downside to early adoption.

If you want more details, we are ready to help.

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