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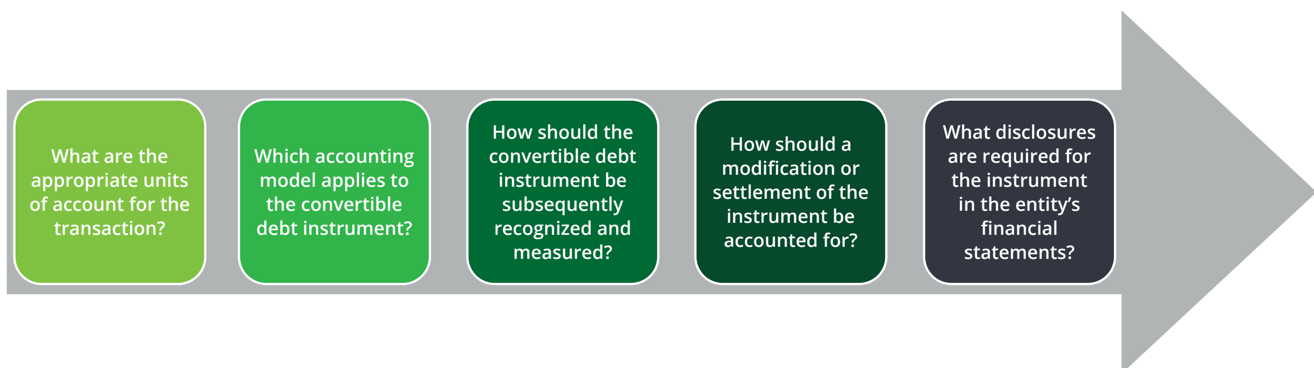
On the Radar

Convertible Debt (Before Adoption of ASU 2020-06)

An entity raising capital by issuing a convertible debt instrument must apply complex financial reporting requirements in U.S. GAAP. To properly account for such an instrument, an entity must consider the following:



Entities often issue convertible debt because it has a lower interest cost than other debt instruments. For example, if an entity is in the growth stage of its life cycle and expects its common stock to increase in fair value, it may issue convertible debt after considering the cost of capital, potential share dilution, and investor demand.

In some cases, an entity may issue convertible debt and simultaneously enter into derivatives (e.g., purchased or written call options on its common stock) to offset the potential share dilution that will occur if the debt instrument is converted into common stock. Although such derivatives generally raise the cost of capital, it may still be more favorable for the entity to issue a combination of convertible debt and derivatives than to issue nonconvertible debt (e.g., lower overall cost of capital or favorable tax benefits). When an entity issues freestanding derivatives on its common stock, the financial reporting and compliance risks increase because of the need to apply complex, rules-based accounting guidance to these instruments. Entities should ensure that they have the appropriate internal controls in place to properly account for and disclose convertible debt instruments and any related derivatives.

Key Questions to Consider

ASC 470-20 provides general guidance on the accounting for convertible debt. However, numerous other sections in U.S. GAAP must also be considered. While the relevant accounting guidance has existed for a number of years, it will change significantly upon an entity's adoption of ASU 2020-06, which amends U.S. GAAP to eliminate the cash conversion feature (CCF) and beneficial conversion feature (BCF) accounting models (see below for further discussion of the accounting models).

As noted above, to determine the appropriate accounting for convertible debt, entities must consider five key questions:

What are the appropriate units of account for the transaction?

In some cases, convertible debt is issued on a stand-alone basis and it is readily apparent that there is only one unit of account. In other financing transactions, convertible debt is issued with detachable warrants or other derivatives intended to offset share dilution. If these other instruments are legally detachable and separately exercisable, they must be accounted for separately from the convertible debt in accordance with other applicable U.S. GAAP. An entity must appropriately allocate the proceeds to each separate unit of account.

Which accounting model applies to the convertible debt instrument?

To select an appropriate accounting model, an entity must first consider whether the embedded conversion feature requires separate accounting as a derivative liability. It must also consider whether other embedded features in the instrument (e.g., put or call options, interest rate adjustments) require separate accounting as derivatives. The allocation of proceeds to a convertible debt instrument may affect whether an embedded derivative feature requires bifurcation.

The evaluation of whether an embedded conversion option requires separate accounting as a derivative liability is performed in accordance with ASC 815; it can be time-consuming and complex. The more unique the terms of a convertible debt instrument, the more likely that the embedded derivative requires bifurcation. The embedded conversion option will require separate accounting as a derivative liability if there are nontraditional adjustments to the conversion rate (e.g., certain make-whole features) or the issuer does not control the ability to settle the conversion option in its common shares.

If the embedded conversion option does not require bifurcation, the entity must consider whether the CCF, BCF, or substantial premium guidance applies. This determination, and the application of this guidance, can be difficult and may require the assistance of accounting advisers. Only if the convertible debt instrument is not within the scope of the CCF, BCF, or substantial premium guidance is the instrument accounted for as a single liability in accordance with the accounting model for traditional convertible debt. See below for further discussion of the accounting models that apply to convertible debt.

How should the convertible debt instrument be subsequently recognized and measured?

The subsequent measurement of convertible debt depends on which accounting model applies. For example, if the conversion option must be accounted for as a derivative instrument, the entity must periodically measure its fair value in accordance with ASC 820, which may require a complex valuation model. In addition, the periodic calculation of interest cost under the interest method will be affected by the amount of proceeds allocated to the convertible debt instrument and the accounting model applied. While some interest calculations are relatively simple, others may be quite complex (e.g., convertible debt with a CCF or BCF). In general, an entity does not subsequently remeasure an equity component that is separately recognized under the CCF, BCF, or substantial premium model.

The balance sheet classification of convertible debt as either current or long-term also depends on the accounting model applied to the instrument. Entities may unexpectedly need to reclassify an instrument's liability component as a current liability on the basis of the investor's ability to convert the instrument (e.g., if the principal amount would be settled in cash upon conversion).

How should a modification or settlement of the instrument be accounted for?

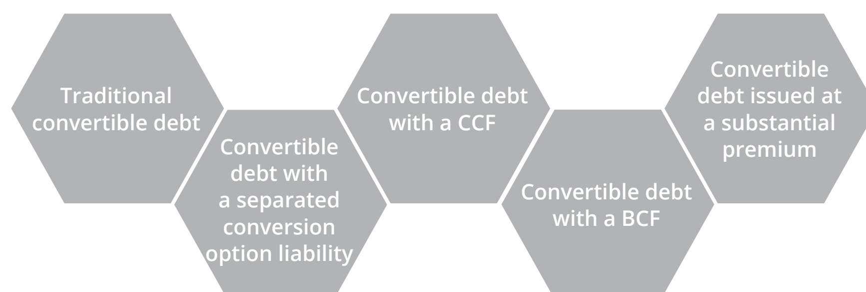
A modification of a convertible debt instrument may represent an extinguishment or require an amount to be recognized in equity. It may also change the accounting model that is applied. Settlements are complex because they may be reflected as extinguishments or conversions depending on the circumstances. Some settlements may reflect induced conversions, which require special accounting considerations.

What disclosures are required for the instrument in the entity's financial statements?

ASC 470-20 specifies the disclosures required for convertible debt. The nature of the required disclosures depends on which accounting model is applied. In addition, the disclosure requirements in other GAAP — such as ASC 405-10, ASC 505-10, ASC 815-10, ASC 815-40, and ASC 820 — may apply, depending on which accounting model is applied to a convertible debt instrument.

Accounting Models for Convertible Debt

Under U.S. GAAP before the adoption of ASU 2020-06, there are five different accounting models for convertible debt instruments that are issued in financing transactions:[1]



The SEC staff closely scrutinizes the appropriate accounting for convertible debt instruments. This is evident in comment letters on registrants' filings and the number of restatements arising from the application of an inappropriate accounting model to convertible debt.

A summary of the different accounting models for convertible debt is as follows:

Type	Scope	Accounting	Compliance and Financial Reporting Considerations
Traditional convertible debt	Convertible debt that does not contain a separated conversion option liability, CCF, BCF, or substantial premium.	**Single liability** *Initial accounting* — Recognize the instrument as a single liability. *Subsequent accounting* — Recognize the liability at amortized cost if the fair value option (FVO) is not elected.	Decreased reported interest cost. Increased liability amount on the balance sheet. Less complex accounting.
Convertible debt with a separated conversion option liability	Convertible debt that contains a conversion option that meets the definition of a derivative and either (1) is not indexed to the company's stock or (2) may require cash settlement upon events or circumstances outside the issuer's control.	**Two liability components** *Initial accounting* — (1) Recognize the conversion option component at fair value and (2) allocate the remaining proceeds to the host liability component. *Subsequent accounting* — Recognize (1) the conversion option liability component at fair value, with changes recognized in earnings, and (2) the host liability component at amortized cost.	Increased reported interest cost. Volatility in earnings because derivative liability is marked to market. Fluctuating aggregate liability amounts on the balance sheet. More complex accounting at inception and on an ongoing basis, including valuation of the conversion option.

[1] Convertible debt instruments issued to employees for service, to nonemployees for goods or services, or to customers are subject to the accounting guidance for share-based payment arrangements.

(Table continued)

Type	Scope	Accounting	Compliance and Financial Reporting Considerations
Convertible debt with a CCF	Convertible debt that (1) does not contain a separated conversion option liability and (2) allows the issuer to fully or partially settle a conversion in cash.	**Liability and equity component** *Initial accounting* — Recognize (1) a liability for the fair value of a similar nonconvertible debt instrument and (2) the remaining proceeds in equity. *Subsequent accounting* — Recognize the liability component at amortized cost. The equity component is generally not subsequently remeasured.	Increased reported interest cost. Decreased reported liability amount on the balance sheet. More complex accounting at inception and upon settlement of the instrument.
Convertible debt with a BCF	Convertible debt that (1) does not contain a separated conversion option liability or CCF and (2) contains a conversion option that is in-the-money to the investor.	**Liability and equity component** *Initial accounting* — Recognize (1) an equity component equal to the intrinsic value of the conversion option and (2) the remaining proceeds as a liability. *Subsequent accounting* — Recognize the liability component at amortized cost. The equity component is generally not subsequently remeasured.	Increased reported interest cost. Decreased reported liability amount on the balance sheet. More complex accounting at inception and upon settlement of the instrument.
Convertible debt issued at a substantial premium	Convertible debt that (1) does not contain a separated conversion option liability, CCF, or BCF and (2) is issued at a significant premium to the stated principal amount.	**Liability and equity component** *Initial accounting* — Recognize (1) the premium as an equity component and (2) the remaining proceeds as a liability. *Subsequent accounting* — Recognize the liability component at amortized cost. The equity component is generally not subsequently remeasured.	Increased reported interest cost. Decreased reported liability amount on the balance sheet. More complex accounting at inception only.

Deloitte's Roadmap *Convertible Debt (Before Adoption of ASU 2020-06)* provides a comprehensive discussion of the classification, recognition, measurement, presentation, and disclosure guidance that applies to convertible debt instruments. For a discussion of an issuer's accounting for convertible debt after the adoption of ASU 2020-06, see Deloitte's Roadmap *Issuer's Accounting for Debt*. Entities should also consider Deloitte's Roadmap *Contracts on an Entity's Own Equity* for guidance on the evaluation of whether the embedded conversion option requires separate accounting as a derivative liability.

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