August 2016

Accounting for Convertible Debt: U.S. GAAP

Executive Summary

- Determine whether the hybrid instrument is within the scope of ASC 480
- If the hybrid instrument is not within the scope of ASC 480, evaluate embedded features for separate accounting under ASC 815
- Conversion options where the underlying shares are not publicly traded generally do not require bifurcation
- Evaluate non-bifurcated conversion options as beneficial conversion features

OVERVIEW

Convertible debt has become an attractive alternative for investors who want to collect interest in the near term but retain the right to convert the debt to equity should the issuer's share price rise in the future. Likewise, many companies are utilizing convertible debt financing to obtain a lower interest rate on their borrowings. While these attributes can be appealing, convertible debt can present unique and complicated accounting matters for the issuer.

Under U.S. GAAP, Convertible debt is considered a "hybrid" financial instrument consisting of interest-bearing debt, referred to as the "host", and certain embedded features requiring evaluation for bifurcation and separate accounting from the host instrument. Convertible debt instruments are typically settled in shares, cash or a combination of the two. To further complicate the accounting, these instruments are often issued with embedded puts, calls, contingent interest features and warrants.

ANALYSIS OF EMBEDDED FEATURES

The first step in accounting for convertible debt is to evaluate the entire hybrid instrument to determine whether it should be liability-classified as a

- Determine whether redemption features are clearly and closely related to the host instrument
- Most redemption features meet the definition of a derivative and do not qualify for a scope exception from ASC 815
- Evaluate contingent interest features for bifurcation; many contingent interest features are deemed immaterial upon issuance
- Record the fair value of bifurcated derivatives as a liability and discount on the debt
- Debt discount should be amortized to interest expense using the effective interest method
- Changes in the fair value of bifurcated derivatives should be recorded in earnings in the period in which they occur
- Under ASU 2015-03, issuance costs should be recorded as a discount on the debt

freestanding financial instrument under Accounting Standards Codification ("ASC") 480, *Distinguishing Liability from Equity*. If the hybrid instrument is within the scope of ASC 480, further analysis under ASC 815, *Derivatives and Hedging,* is not required and the entire instrument is marked-to-market at each reporting date. Provided the hybrid instrument is not within the scope of ASC 480, the next step is to evaluate each embedded feature for bifurcation under ASC 815. In identifying the embedded features, companies should consider any provision that could potentially impact the timing or amount of cash or shares exchanged. The most common features are addressed below.

Embedded Conversion Options

ASC 815-15-25-1 provides the following guidance for determining whether an embedded feature should be accounted for separately as a derivative:

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.

Close attention should be paid to the substance rather than the form of any conversion feature. A conversion feature that provides the investor with a variable number of shares with an aggregate fair value equaling the debt principal outstanding should be evaluated as a redemption feature rather than a conversion option. Alternatively, a conversion feature that provides the investor with a fixed number of shares such that the value received is based on the underlying value of the equity should be evaluated as a 'true' conversion option.

Clearly and closely related
A debt host instrument's characteristics are most closely associated with credit risk and interest rates. An embedded conversion option is not generally considered clearly and closely related to a debt host because the value of the conversion option is linked to the value of the underlying equity.

Hybrid instrument not remeasured at fair value
Unless the Company has elected the fair value option for the hybrid instrument, it generally will not be remeasured at fair value at each reporting date.

Meets the definition of a derivative
ASC 815-10-15-83 provides guidance for determining whether the conversion option meets the definition of a derivative. There are four characteristics, all of which must be met, to meet the definition of a derivative: (i) underlying; (ii) a notional amount; (iii) no initial net investment; and, (iv) net settlement. Net settlement is generally the most critical characteristic when making this determination. If the underlying shares are not publicly traded, they are not considered readily convertible to cash and the conversion option would not be considered net settled. If the conversion option meets the definition of a derivative, companies should assess whether it qualifies for the scope exception for contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

Beneficial Conversion Feature
Conversion options that do not require bifurcation may require further evaluation as a beneficial conversion feature if the value the holder receives upon conversion varies with the value of the underlying shares.

Embedded puts or calls
Commonly referred to as redemption features, embedded puts and calls can accelerate the repayment of the debt. As outlined above, ASC 815-15-25-1 provides the criteria for determining whether an embedded put or call should be bifurcated from the host instrument as a derivative.

Clearly and closely related
ASC 815-15-25-42 and 43 provides a four step process for determining whether a put or call is considered clearly and closely related to a debt host. Generally, puts and calls are considered clearly and closely related to a debt

host unless they are leveraged. For example, a put feature that can require redemption at three times the par value may not be considered clearly and closely related to the host instrument if the debt was issued at par value.

Meets the definition of a derivative

Embedded puts or calls that are not considered clearly and closely related to the host instrument should be further evaluated to determine whether they meet the definition of a derivative. Most embedded puts and calls meet the definition of a derivative and do not qualify for a scope exception from ASC 815.

CONTINGENT INTEREST FEATURES

Some debt instruments require additional interest payments upon the occurrence of certain events, such as default. A contingent interest feature that meets the definition of derivative is considered clearly and closely related to a debt host if it is indexed solely to interest rates or credit risk. Many companies assess the likelihood of paying contingent interest to be remote upon issuance concluding that the value of such a feature is immaterial at the issuance date.

ACCOUNTING FOR SEPARATED FEATURES

If an issuer concludes that any of the embedded features should be bifurcated and accounted for as derivatives, the issuer should determine the fair value of these features upon issuance and record them on the balance sheet as a derivative liability with a corresponding amount recorded as debt discount. This discount should be amortized to interest expense using the effective interest method. Any changes in fair value of the derivative liability subsequent to issuance should be recognized in the income statement in the period in which the change occurs.

ISSUANCE COSTS

Provided that the issuer has elected to adopt Accounting Standards Update ("ASU") 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, any debt issuance costs will be recorded as a discount on the debt and amortized to interest expense using the effective interest method.

WilliamsMarston LLC

- Former Big Four experts with deep industry, operational and technical accounting experience
- Actionable insights into the latest technical accounting and financial reporting developments

HOW WE CAN HELP

With offices in Boston and New York, WilliamsMarston LLC is comprised of former Big Four accounting experts. Our professionals routinely advise pre-IPO and public companies on the accounting and reporting for complex transactions, including initial public offerings, mergers and acquisitions, revenue recognition, debt and equity instruments, variable interest entities, and stock based compensation amongst many others. Chief Financial Officers and Controllers rely on WilliamsMarston for assistance with their most complex accounting and reporting initiatives.

Boston Office
800 Boylston Street
16th Floor
Boston, MA 02199
www.williamsmarston.com

New York Office
375 Park Avenue
Suite 2607
New York, NY 10152
www.williamsmarston.com

Landen C. Williams
Partner – Boston
Phone: (617) 306-0951
landen@williamsmarston.com

Michael R. Donoso
Managing Director – New York
Phone: (646) 757-0572
mdonoso@williamsmarston.com

Jonathan T. Marston
Partner – Boston
Phone: (617) 851-0891
jon@williamsmarston.com

Accounting for convertible debt is complicated and dependent on the terms and conditions of the specific instrument. This whitepaper contains general information only. By virtue of this whitepaper, WilliamsMarston LLC is not rendering business, accounting, financial, investment, legal, tax or other professional advice or services. The statements contained in this whitepaper are not intended to be a substitute for any accounting literature or SEC regulations. Companies applying U.S. GAAP or filing financial information with the SEC should apply the relevant laws and regulations and consult a qualified accounting advisor.