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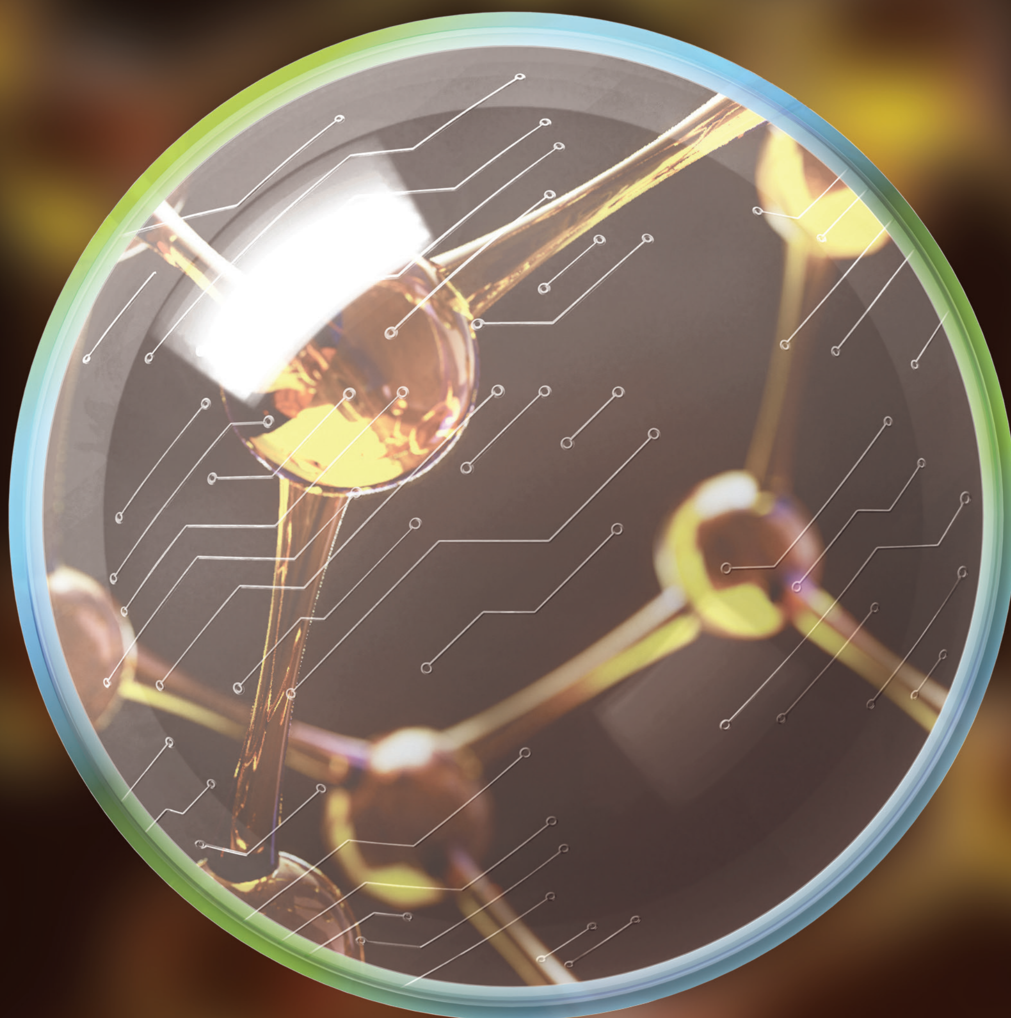

Life Sciences Industry Accounting Guide
Financial Instruments

March 2024

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Preface

The life sciences ecosystem encompasses a wide array of entities that discover, develop, and manufacture health care products. Such entities include pharmaceutical manufacturers; biotechnology companies; medical device, diagnostic, and equipment manufacturers; and service companies such as drug distributors, contract research organizations (CROs), contract manufacturing organizations (CMOs), and health technology companies.

Finance and accounting professionals in the life sciences industry face complex issues and must exercise significant judgment in applying existing rules to matters such as research and development (R&D) costs, acquisitions and divestitures, consolidation, contingencies, revenue recognition, income taxes, financial instruments, and financial statement presentation and disclosure. The 2024 edition of Deloitte's *Life Sciences Industry Accounting Guide* (the "Guide") addresses these and other relevant topics affecting the industry this year. It includes interpretive guidance, illustrative examples, recent standard-setting and rulemaking developments (through March 8, 2024), and key differences between U.S. GAAP and IFRS® Accounting Standards. In addition, this Guide discusses (1) accounting and financial reporting considerations associated with the macroeconomic and geopolitical environment that apply specifically to the life sciences industry, (2) environmental, social, and governance (ESG) matters that have become topics of increased focus, and (3) the impact of the Inflation Reduction Act of 2022 (IRA).

Appendix B lists the titles of standards and other literature we cited, and Appendix C defines the abbreviations we used. Key changes made to this Guide since publication of the 2023 edition are summarized in Appendix D.

We hope the Guide is helpful in navigating the various accounting and reporting challenges that life sciences entities face. We encourage clients to contact their Deloitte team for additional information and assistance.

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Chapter 10 — Financial Instruments

10.1 Introduction

Drug development is challenging, complex, time-consuming, and costly. Even though the average cost of developing a compound from discovery to launch has declined in recent years as the industry has begun to capitalize on the development of novel trial designs and realize efficiencies from the digitalization of drug discovery and development, billions of dollars are spent each year developing new drugs.[1] To fund the cost of drug development, life sciences entities frequently seek external financing. Many of the financing transactions include complex terms and conditions that require a careful accounting analysis.

The SEC staff historically has focused on the classification of liabilities and equity on the balance sheet when equity instruments have redemption provisions or financial instruments possess characteristics of both liabilities and equity. For example, classification of convertible debt instruments and freestanding warrants is often scrutinized since they may contain both liability and equity components under U.S. GAAP.

In addition, prospective SEC registrants in the life sciences industry may have previously outstanding instruments with characteristics of both liabilities and equity at the time they are approaching a potential IPO, or life sciences entities may issue new instruments in connection with a potential IPO. Even if certain instruments are already outstanding before an IPO, it may be appropriate for an instrument to be classified outside of permanent equity in accordance with SEC rules when public financial statements are initially filed. Further, for a life sciences entity that becomes a public company, there can be other accounting consequences that did not exist while the entity was private.

10.2 Industry Issues

The discussion below highlights guidance on the accounting for financial instruments that frequently affects life sciences entities. The guidance cited is not intended to be all-inclusive or comprehensive; rather, the discussion focuses on targeted considerations related to the application of the guidance most relevant to the industry. To complete an analysis of the accounting for financial instruments, entities must consider all facts and circumstances and use significant judgment. For additional guidance on the topics highlighted below, see Deloitte's Roadmaps *Distinguishing Liabilities From Equity*, *Contracts on an Entity's Own Equity*, and *Convertible Debt (Before Adoption of ASU 2020-06)*.

[1] See, for example, the Deloitte Centre for Health Solutions' 13th annual pharmaceutical report, *Seize the Digital Momentum: Measuring the Return From Pharmaceutical Innovation 2022*.

10.2.1 Sequence of Decision-Making

Upon the issuance of an equity instrument, a life sciences entity should first evaluate whether the instrument meets the definition of a liability in accordance with ASC 480, which applies to both PBEs (including SEC registrants) and private companies that are issuers of financial instruments within its scope. ASC 480 provides guidance on determining whether (1) certain financial instruments with both debt-like and equity-like characteristics should be accounted for "outside of equity" (i.e., as liabilities or, in some cases, assets) by the issuer and (2) SEC registrants should present certain redeemable equity instruments as temporary equity.

Examples of contracts and transactions that may require evaluation under ASC 480 include:

- Redeemable shares.
- Redeemable noncontrolling interests.
- Forward contracts to repurchase own shares.
- Forward contracts to sell redeemable shares.
- Written put options on own stock.
- Warrants (and written call options) on redeemable equity shares.
- Warrants on shares with deemed liquidation provisions.
- Puttable warrants on own stock.
- Equity collars.
- Share-settled debt (i.e., a share-settled obligation that is not in the legal form of debt but has the same economic payoff profile as debt).
- Preferred shares that are mandatorily convertible into a variable number of common shares.
- Unsettled treasury stock transactions.
- Accelerated share repurchase (ASR) programs.
- Hybrid equity units.

However, ASC 480 does not apply to legal-form debt, which is always classified as a liability by the issuer. If the legal form of an instrument is equity, further evaluation is necessary.

ASC 480 applies only to items that have all of the following characteristics:

- They embody one or more obligations of the issuer. An obligation can be either unconditional or conditional. An obligation is unconditional if no condition needs to be satisfied (other than the passage of time) to trigger a duty or responsibility for the obligated party to perform. Examples of unconditional obligations include:
  - Mandatorily redeemable financial instruments (as defined in ASC 480-10-20).
  - Physically settled forward contracts that require the issuer to repurchase equity shares by transferring assets or a variable number of shares.
  - Preferred stock that mandatorily converts into a variable number of common shares.

An obligation is conditional if the obligated party only has a duty or responsibility to perform if a specified condition is met (e.g., the occurrence or nonoccurrence of an uncertain future event or the counterparty's election to exercise an option). Examples of conditional obligations include:

  - Physically settled written put options that, if exercised, could require the issuer to purchase equity shares and transfer assets.
  - Physically settled forward contracts that require the issuer to purchase equity shares upon the occurrence or nonoccurrence of an event that is outside the issuer's control.
  - Net-settled forward contracts to purchase equity shares that could require the issuer to transfer cash or a variable number of equity shares to settle the contracts' fair value if they are in a loss position.
  - Net-settled written options that require the issuer to transfer assets or shares if the counterparty elects to exercise the options.

  ASC 480 does not address the accounting for financial instruments that do not embody any obligation of the issuer. Examples of such instruments include:

  - Outstanding equity shares that do not have any redemption or conversion provisions.
  - Purchased call options that permit but do not require the issuer to purchase equity shares for cash (see ASC 480-10-55-35).
  - Purchased put options that permit but do not require the issuer to sell equity shares for cash.

- They meet the definition of a financial instrument. The scope of ASC 480 is limited to financial instruments, which include:
  - Ownership interests (e.g., common or preferred shares or interests in a partnership or limited liability company).
  - Contracts to deliver cash (e.g., net-cash-settled options or forward contracts).
  - Contracts to deliver shares (e.g., share-settled debt or net-share-settled options or forward contracts).
  - Contracts to exchange financial instruments (e.g., physically settled written options or forward contracts that involve the exchange of equity shares for cash or another financial asset).
- They meet the definition of a freestanding financial instrument; that is, they are not features embedded in a freestanding financial instrument. ASC 480-10-20 defines a freestanding financial instrument as a financial instrument that either (1) "is entered into separately and apart from any of the entity's other financial instruments or equity transactions" or (2) "is entered into in conjunction with some other transaction and is legally detachable and separately exercisable."
- Their legal form is that of a share, or they could result in the receipt or delivery of shares or are indexed to an obligation to repurchase shares.

ASC 480 requires an instrument that has all of the above characteristics to be classified outside of equity if it falls within one of the following classes of instruments:

- *Mandatorily redeemable financial instruments* — The issuer of a financial instrument that is in the form of a share must classify the share as a liability if it embodies an unconditional obligation requiring the issuer to redeem the share by transferring assets unless redemption would occur only upon the liquidation or termination of the reporting entity. Examples of mandatorily redeemable financial instruments include those mandatorily redeemable shares and mandatorily redeemable noncontrolling interests that do not contain any substantive conversion features.
- *Obligations to repurchase the issuer's shares by transferring assets (or financial instruments indexed to such obligations)* — A financial instrument other than an outstanding share is classified as an asset or a liability if it both (1) embodies an obligation to repurchase the issuer's equity shares (or is indexed to such an obligation) and (2) requires (or may require) the issuer to settle the obligation by transferring assets. Examples of financial instruments that meet these criteria include those forward purchase contracts and written put options on the entity's own equity shares that are either physically settled or net cash settled.
- *Certain obligations to issue a variable number of shares* — An outstanding share that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies an obligation, is classified as an asset or a liability if the issuer must or may settle the obligation by issuing a variable number of its equity shares and the obligation's monetary value is based solely or predominantly on one of the following: (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares. Examples of instruments in this category include share-settled debt and those forward purchase contracts and written put options on the entity's own equity shares that are net share settled.

Financial instruments that are accounted for as assets or liabilities under ASC 480 are initially recognized at fair value, with one exception. A forward contract that requires the entity to repurchase a fixed number of its equity shares for cash is initially measured at the fair value of the shares at inception (i.e., not the fair value of the forward contract), with certain adjustments, and the offsetting entry is presented in equity (i.e., the transaction is treated as if the repurchase had already occurred with borrowed funds).

In subsequent periods, financial instruments classified as assets or liabilities under ASC 480 are remeasured at their then-current fair value, and changes in fair value are recorded in earnings, with two exceptions. ASC 480-10-35-3 states that physically settled forward contracts to repurchase "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," as applicable:

> 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.

The fact that an instrument does not need to be classified as an asset or a liability under ASC 480 does not necessarily mean that it qualifies for equity classification. To determine whether an instrument qualifies for classification in equity in whole or in part, an entity must also consider other GAAP (e.g., ASC 470-20, ASC 815-10, ASC 815-15, and ASC 815-40). Further, under ASC 480-10-S99-3A, an entity that is subject to SEC guidance should consider whether an equity-classified instrument must be classified outside of permanent equity.

Once an issuer has determined that the appropriate balance sheet classification for the equity instrument is liability, temporary equity, or permanent equity, the issuer should further evaluate the instrument to identify any embedded features that may need to be bifurcated and accounted for separately as derivative instruments.

The sections below outline some of the more common types of securities that life sciences entities issue, together with the related accounting considerations.

10.2.2 Redeemable Equity Securities

The SEC staff believes that redeemable equity securities are significantly different from conventional equity capital because such securities possess characteristics similar to debt as a result of the redemption obligation attached to the securities. The guidance in ASC 480-10-S99-3A requires instruments to be classified outside of permanent equity in "temporary equity" if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the issuer's control. To determine the appropriate classification, SEC registrants must evaluate all facts and circumstances related to events that could trigger redemption of the securities.[2] Issuers should evaluate whether equity instruments that do not meet the definition of a liability under ASC 480 nevertheless must be presented outside of permanent equity because of any of these provisions.

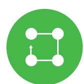
Because only public entities are required to present certain equity instruments as temporary equity (sometimes referred to as mezzanine equity) instead of permanent equity, the SEC staff frequently comments on this topic during the IPO process.

10.2.2.1 Mandatorily Redeemable Equity Securities

ASC 480 requires mandatorily redeemable securities to be reported as liabilities. Other redeemable equity securities are classified outside of shareholders' equity in "temporary equity" under the SEC staff's guidance. More specifically, for a redeemable equity security to be classified as a liability under ASC 480, it must be certain that redemption will occur; redeemable equity securities whose redemption is not certain are classified as temporary equity under the SEC staff's guidance. Therefore, mandatorily redeemable preferred securities that have substantive conversion options at issuance would not be considered liabilities under ASC 480 even though such securities are called mandatorily redeemable convertible securities. This is because as long as the conversion option is substantive, it is not certain that redemption will occur. If the issuer does not have control over any event that could trigger redemption of the security, the security would be classified as temporary equity under the SEC staff's guidance.

The treatment of the return paid to the holder of redeemable securities differs depending on whether the securities are classified as liabilities or as temporary equity. For securities classified as liabilities under ASC 480, such a return is treated as an expense. For redeemable securities classified as temporary equity, such a return is treated as a dividend.

[2] See ASC 480-10-S99-3A(5).

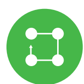


Connecting the Dots

In general, an entity should first apply the guidance in ASC 480 when determining the appropriate presentation of redeemable securities on the balance sheet. If the securities are not classified as liabilities under ASC 480, the entity should examine them under SEC staff guidance to determine whether it is appropriate to classify them as temporary equity. In addition, registrants should be familiar with the SEC staff's views on the applicability of its guidance in certain situations. For example, if redemption is required only upon the liquidation of the reporting entity, an instrument is not considered redeemable. This situation and others are described in ASC 480-10-S99-3A.

10.2.2.2 Redeemable Securities Whose Redemption Is Outside the Issuer's Control

The analysis of whether a security's redemption is not solely within the issuer's control could be complicated depending on the triggering events associated with redemption. The SEC staff believes that the issuer should evaluate each triggering event separately, along with relevant facts and circumstances, to determine whether it is outside the issuer's control. If *any* triggering events are outside the issuer's control, the security should be classified outside of permanent equity regardless of the probability of such events.[3] ASC 480-10-S99-3A-6 through S99-3A-9 provide examples of events that are outside the issuer's control.



Connecting the Dots

Nonpublic life sciences entities, including start-ups and other entities financed by private equity or venture capital firms, often have one or more series of convertible preferred stock issued and outstanding. In evaluating the appropriate classification in the statement of financial position of convertible preferred stock, a life sciences entity should first consider whether the convertible preferred stock represents a mandatorily redeemable financial instrument that is required to be classified as a liability under ASC 480-10-25-4. If a preferred stock instrument contains an embedded conversion option that is considered a substantive feature as of the issuance date,[4] the convertible preferred stock instrument would not qualify as a mandatorily redeemable financial instrument.[5]

When convertible preferred stock is not required to be classified as a liability, life sciences entities should consider the SEC staff's guidance in ASC 480-10-S99-3A to determine whether it is appropriate to classify the convertible preferred stock in permanent equity. Convertible preferred stock should be classified in temporary equity if the instrument contains (1) a stated redemption feature that allows or requires the holder to put the security to the issuer on a specified date (or dates) or (2) a stated redemption feature that allows the holder to put the security to the issuer upon the occurrence of a specified event that is not solely within the issuer's control. Therefore, when the holders of convertible preferred stock have control over the entity, the following convertible preferred stock instruments must also be classified in temporary equity:

- Convertible preferred stock that contains a stated redemption feature that allows the issuer to call the security on a specified date (or dates).

[3] See footnote 2.

[4] A conversion feature that results in settlement of the instrument through the issuance of a variable number of shares of common stock equal to a fixed monetary amount is equivalent to "share-settled" debt and would not represent a substantive conversion option. For additional guidance, see ASC 470-20-40-5 through 40-10.

[5] See ASC 480-10-55-11 and 55-12.

- Convertible preferred stock that contains a stated redemption feature that allows the holder to put the security to the issuer upon the occurrence of a specified event or circumstance that can be controlled by the vote of the entity's stockholders or by actions of the entity's board of directors.

Even if a convertible preferred stock instrument does not contain an explicit redemption feature (i.e., a stated call option or a stated put option), the instrument's liquidation provisions must still be considered, including whether those provisions are considered "ordinary liquidation" or "deemed liquidation" provisions. An ordinary liquidation provision does not trigger the requirement to classify the convertible preferred equity in temporary equity; a deemed liquidation provision will typically trigger the requirement to classify the convertible preferred equity in temporary equity. See Chapter 9 of Deloitte's Roadmap *Distinguishing Liabilities From Equity* for additional guidance.

10.2.2.3 Measurement of Instruments Classified in Temporary Equity

If an instrument classified in temporary equity is currently redeemable, it should be adjusted to its maximum redemption amount as of the balance sheet date. However, if an instrument classified in temporary equity is not currently redeemable and the registrant determines that its redeemability is not probable, subsequent adjustment of the carrying amount is not necessary until it is probable that the security will become redeemable.[6]

10.2.3 Preferred Stock That Is Nonredeemable or Is Redeemable Solely at the Option of the Issuer

When securities are not redeemable or are redeemable solely at the option of the issuer, those securities are generally classified in permanent equity on the balance sheet. All relevant facts and circumstances should be considered in the determination of whether the redemption is solely at the option of the issuer.[7] The SEC staff often emphasizes that issuers should examine the redemption provision of all securities classified in permanent equity to ensure their proper classification. For example, an instrument may not be redeemable for cash but may be convertible into another class of equity. Unless management can assert that it has the ability to settle the conversion with shares, it could be forced to redeem the instrument for cash, resulting in classification of that instrument outside of permanent equity. In addition, according to its terms, a security may be redeemable solely at the option of the issuer; however, if the holder of the security controls the issuer's board of directors, that security would be considered redeemable at the option of the holder and would be classified as temporary equity.[8]

If classification of securities as temporary equity is no longer appropriate because of a change in the redemption feature, the outstanding carrying amount of securities should be reclassified as permanent equity on the date of the event that causes the reclassification.

Even if the entire instrument should be classified in permanent equity under ASC 480-10-S99-3A, the issuer may be required to perform further analysis to determine whether the equity instrument contains embedded derivatives that must be bifurcated and accounted for separately as derivative instruments in accordance with ASC 815-15.

[6] See ASC 480-10-S99-3A(15).
[7] See ASC 480-10-S99-3A(11).
[8] See ASC 480-10-S99-3A(7).

10.2.4 Conversion Features of Preferred Stock and Debt

As discussed in Section 10.2.6.2, an issuer should perform an evaluation under ASC 815 to determine whether contracts, such as those involving convertible preferred stock or convertible debt, contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. If an embedded conversion feature does not need to be bifurcated from the hybrid instrument as an embedded derivative, but the convertible instrument contains beneficial conversion features (BCFs) or may be settled entirely or partially in cash, the instrument may need to be separated into a liability component and an equity component. After concluding that a conversion option does not need to be bifurcated under ASC 815, an issuer should consider whether the cash conversion guidance in ASC 470-20 applies. If the hybrid instrument is not within the scope of the cash conversion guidance, the issuer should consider the BCF guidance in ASC 470-20. Both the cash conversion guidance and the BCF guidance in ASC 470-20 are discussed below.

Connecting the Dots

In August 2020, the FASB issued ASU 2020-06, which simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity's own equity. The ASU is part of the FASB's simplification initiative, which aims to reduce unnecessary complexity in U.S. GAAP. ASU 2020-06 removes the separation models in ASC 470-20 for (1) convertible debt with a cash conversion feature (CCF) and (2) convertible instruments with a BCF. As a result, after adopting the ASU's guidance, entities will not separately present in equity an embedded conversion feature in such debt. Instead, they will account for a convertible debt instrument wholly as debt, and for convertible preferred stock wholly as preferred stock (i.e., as a single unit of account), unless (1) a convertible instrument contains features that require bifurcation as a derivative under ASC 815 or (2) a convertible debt instrument was issued at a substantial premium. Under current guidance, applying the separation models in ASC 470-20 to convertible instruments with a BCF or CCF involves the recognition of a debt discount, which is amortized to interest expense. The elimination of these models will reduce reported interest expense and increase reported net income for entities that have issued a convertible instrument that was within the scope of those models before the adoption of ASU 2020-06.

For more information about ASU 2020-06, see Section 10.3.5.

10.2.4.1 Cash Conversion Features

As discussed above, an issuer should evaluate whether a convertible instrument must be accounted for under the cash conversion guidance in ASC 470-20 if the conversion feature did not need to be bifurcated in accordance with ASC 815-15. The cash conversion guidance applies only to convertible debt that may be settled in whole or in part in cash upon conversion. Typically, the convertible debt will allow the issuer to settle the par amount in cash and to deliver shares with a fair value equal to the intrinsic value of the conversion option.

Issuers of both convertible debt and convertible preferred stock should consider the cash conversion guidance in ASC 470-20; however, since this guidance applies only to convertible debt, all of the following four conditions must be met for the guidance to apply to convertible preferred stock:

- Upon conversion, the preferred stock may be settled either fully or partially in cash or assets in accordance with its stated terms.
- The convertible preferred stock meets the definition of a mandatorily redeemable financial instrument in ASC 480.

- The convertible preferred stock is classified as a liability under ASC 480 (i.e., it is a mandatorily redeemable financial instrument that is not excluded from the scope of ASC 480).
- The CCF is not required to be separately accounted for as a derivative instrument under ASC 815-15.

Equity-classified convertible preferred stock (including preferred stock classified in temporary equity) is outside the scope of the cash conversion guidance in ASC 470-20. In general, mandatorily convertible preferred stock is also outside the scope of the cash conversion guidance in ASC 470-20 because it will be classified as a liability only if (1) the conversion option is not considered substantive at issuance or (2) the issuer, upon conversion, had to settle a portion of that conversion in cash (the issuance of cash for fractional shares can be ignored).

A convertible debt instrument would not be within the scope of the ASC 470-20 cash conversion guidance if cash settlement would occur only when all other holders of the underlying shares also receive cash. Further, convertible debt that provides for the settlement of fractional shares in cash upon conversion would not be within the scope of the cash conversion guidance.

The debt and equity components of instruments within the scope of the cash conversion guidance must be accounted for separately. To account for those components, the issuer first determines the fair value of a similar liability without the conversion option, which represents the liability (debt) portion of the instrument. The remainder of any proceeds allocated to the convertible instrument is allocated to the conversion (equity) portion. The method used to determine the value of a CCF (i.e., based on the fair value of the debt component) differs from the approach discussed below to determine the value of a BCF (i.e., based on the intrinsic value of the equity component).

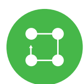
10.2.4.2 Beneficial Conversion Features

ASC 470-20-20 defines a BCF as a "nondetachable conversion feature that is in the money at the commitment date." If the conversion price embedded in preferred stock or debt is lower than the fair value of the stock into which the preferred stock or debt is convertible as of the commitment date and the conversion feature does not need to be bifurcated as an embedded derivative, the conversion feature may be "beneficial." If the conversion feature is beneficial, the effect of the difference between the conversion price and the fair value of the stock should reduce the carrying amount of the convertible instrument and be recognized in equity.

Connecting the Dots

In determining whether a BCF exists, an entity should consider the "effective conversion price" that an investor effectively would pay for a share upon conversion. For instance, if convertible debt was issued at a discount or a portion of the proceeds was allocated to detachable warrants, an entity would calculate the effective conversion price of the debt by using the amount allocated to the debt for accounting purposes.

The SEC staff frequently seeks to identify embedded BCFs by analyzing the conversion price in convertible instruments issued within one year of an IPO filing. When the conversion price is lower than the IPO price, the SEC staff may require a prospective registrant to recognize an expense related to a BCF and may sometimes require it to use the IPO price as a base in measuring the BCF. If the prospective registrant believes that the conversion price represented the stock's fair value at the time the instrument was issued, it should be prepared to present sufficient evidence to support its assertion.



Connecting the Dots

Identifying a BCF can be complex because it is directly related to the appropriateness of the fair value assigned to the underlying stock when that stock is not actively traded.

Once an entity identifies a BCF, the entity would recognize that embedded feature separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of the embedded feature to additional paid-in capital. If a BCF is contingent on the occurrence of a future event such as an IPO, an entity would measure the BCF in the same way but would not recognize it in earnings until the contingency is resolved.

10.2.5 Accelerated Share Repurchase Programs

Several life sciences companies have considered or executed ASR programs in recent years. As described in ASC 505-30-25-5, an ASR program is "a combination of transactions that permits an entity to repurchase a targeted number of shares immediately with the final repurchase price of those shares determined by an average market price over a fixed period of time. An accelerated share repurchase program is intended to combine the immediate share retirement benefits of a tender offer with the market impact and pricing benefits of a disciplined daily open market stock repurchase program."

ASC 505-30 contains unit-of-account guidance that applies to ASR programs. Under ASC 505-30-25-6, an entity accounts for an ASR as two separate units of account: a treasury stock repurchase and a separate forward contract on the entity's shares. An entity should analyze the treasury stock repurchase and forward contract separately to determine whether ASC 480 applies.

The terms of ASRs vary. In a traditional ASR, an entity (1) repurchases a targeted number of its own shares at the current stock price up front for cash and (2) simultaneously enters into a net-settled forward sale of the same number of shares. Economically, the forward serves as a true-up mechanism to adjust the price ultimately paid for the shares purchased. The purpose is to reduce the number of outstanding shares immediately at a repurchase price that reflects the average stock market price over an extended period (e.g., the volume-weighted average price on each trading day during the contract period). On a combined basis, the initial share repurchase and the forward sale put the issuer in an economic position similar to that of having conducted a series of open market purchases of its own stock over a specified period.

Example 10-1

ASR Analysis — Determination of Units of Account

An entity makes an up-front cash payment and receives a specific number of shares from the counterparty (usually an investment bank). Upon settlement of the forward contract (typically within three to six months), the entity either (1) pays the counterparty an amount equal to any excess of the volume-weighted average daily market price (VWAP) of the entity's shares over the initial purchase price or (2) receives from the counterparty an amount equal to any excess of the initial purchase price over the VWAP. Often, the entity can choose to settle the forward contract with the counterparty in either cash or a variable number of shares. Under ASC 505-30, this transaction is analyzed as two units of account: a treasury stock repurchase and a net-settled forward contract to sell the entity's stock over the contract period.

In practice, the settlement of the treasury stock repurchase often takes place one or a few days after the execution of the ASR (e.g., the initial share delivery date may be three business days after the transaction date), at which time the issuer pays cash and receives an initial number of shares. If so, the obligation to repurchase shares in exchange for cash is classified as a liability under ASC 480-10-25-8 (see Chapter 5 of Deloitte's Roadmap *Distinguishing Liabilities From Equity*) during the period between the ASR transaction date and the settlement date of the treasury stock repurchase (sometimes described as the "initial share delivery date" or the "prepayment date"). Note that in some ASR transactions, the payment of cash in the treasury stock repurchase occurs before the receipt of the initial shares, in which case ASC 480 may cease to apply once the obligation to pay cash has been settled.

In evaluating whether the forward component of an ASR is within the scope of ASC 480, the issuer should consider whether it embodies an obligation to transfer assets or a variable number of shares that meet the criteria in ASC 480-10-25-8 or ASC 480-10-25-14 (see Chapters 5 and 6, respectively, of Deloitte's Roadmap *Distinguishing Liabilities From Equity*). Usually, an issuer is not required to classify as a liability under ASC 480 the forward contract component in a traditional ASR because it does not embody an obligation to repurchase shares for assets and does not involve an obligation to deliver a variable number of shares with a monetary value that moves inversely with — or is based on something other than — the price of the issuer's stock. However, an issuer cannot assume that the forward contract component of an ASR is outside the scope of ASC 480 without analyzing its specific terms and features.

In some ASR transactions, a portion of the prepayment amount on the initial share delivery date represents a premium paid by the issuer to increase the forward sale price that the issuer will receive in the forward component of the transaction (relative to an at-market forward) rather than a payment for the shares to be received in the initial treasury stock repurchase. For example, the issuer may apply 20 percent of the prepayment amount to the forward component to reduce the likelihood that the forward component will ever dilute earnings per share (EPS). In this case, the issuer may be required to account for the forward component as an asset or liability under ASC 480-10-25-8 in the period between the transaction date and the prepayment date (which may be the initial share delivery date) if the forward component permits net share settlement, because the forward component embodies an obligation to pay cash (on the initial share delivery date) to repurchase shares (the issuer will receive shares on the forward settlement date if the stock price is less than the forward price).

If the forward component is outside the scope of ASC 480, the issuer should evaluate it under ASC 815-40 to determine whether it must be accounted for as an asset or a liability. The terms of an ASR often include rights for the counterparty to end the ASR early upon termination events defined by reference to the International Swaps and Derivatives Association's equity derivatives definitions (e.g., merger events, tender offers, nationalization, insolvency, delisting, change in law, failure to deliver, loss of stock borrowings, increased cost of stock borrowings, extraordinary dividends). Further, the contractual provisions often specify or permit the counterparty to make adjustments to the settlement terms upon the occurrence of such events (e.g., calculation agent adjustments, cancellation, and payment) and might require the entity to settle the contract net in cash. In evaluating an ASR's forward-contract component under ASC 815-40, the entity should be mindful of the need to assess such terms under the indexation guidance and other equity classification conditions in ASC 815-40.

Example 10-2

ASR Analysis — Accounting Between Trade Date and Settlement Date

On December 30, an issuer enters into an ASR transaction that requires it to transfer a fixed amount of cash (a prepayment amount of $500 million) in exchange for a fixed number of its common shares (10 million initial shares) on the initial share delivery date (January 2). On the transaction's final settlement date (March 31), the issuer will either deliver or receive shares. If the VWAP of the issuer's common shares exceeds $50, the issuer will deliver shares; if the VWAP is less than $50, the issuer will receive shares. The number of shares that will be received or delivered is calculated as the prepayment amount ($500 million) divided by the VWAP over the contract period less the initial shares (10 million) already delivered.

In these circumstances, the treasury stock repurchase must be accounted for as a liability under ASC 480-10-25-8. In accordance with ASC 480-10-30-3, the issuer recognizes the liability on the ASR transaction date, which was initially measured "at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges." Simultaneously, in accordance with ASC 480-10-30-5, equity is "reduced by an amount equal to the fair value of the shares at inception." Because under ASC 480-10-35-3(a) both the amount to be paid ($500 million) and the settlement date (January 2) are fixed, the liability is measured at the present value of the amount to be paid at settlement ($500 million), with interest cost accruing at the rate implicit at inception during the period from the transaction date to the initial share delivery date. (Further, if any part of the prepayment amount represents a premium payment for the forward component of the ASR transaction, that portion would be accounted for separately as a liability measured at fair value under ASC 480-10-35-1, ASC 480-10-35-4A, or ASC 480-10-35-5 between the transaction date and the initial share delivery date, as discussed above.)

On the initial share delivery date, the liability for the treasury stock repurchase is extinguished by delivery of the prepayment amount. After the initial share delivery date, the transaction is outside the scope of ASC 480 and is therefore evaluated under other GAAP (including ASC 815-10 and ASC 815-40; see Section 3.2.5 of Deloitte's Roadmap *Contracts on an Entity's Own Equity*).

10.2.6 Derivatives

Common financing arrangements issued by life sciences entities in the form of debt or equity capital may be considered to be or may contain equity derivatives (i.e., equity derivatives may be freestanding or embedded). Examples of common equity derivatives are stock warrants, stock options, and forward contracts to buy or sell an entity's shares. Equity derivatives may be classified as liabilities (or, in some cases, as assets) and measured at fair value on the balance sheet, with changes in fair value recognized in earnings. It is important to be aware of these instruments, how they are accounted for, and subsequent events that could affect such accounting. Sometimes, the measurement attribute for such instruments could be fair value as a result of an IPO or subsequent financing.

The first step in the analysis is to consider whether the equity derivative is a freestanding instrument or whether it is embedded in another instrument. If the instrument is freestanding, the guidance in ASC 815-40 will govern the classification and measurement of the instrument unless the instrument is a liability within the scope of ASC 480, as discussed above. It is important to note that the guidance in ASC 815-40 is applicable to freestanding contracts on an entity's own equity regardless of whether those contracts meet the definition of a derivative in ASC 815-10. Contracts on an entity's own equity may need to be classified as assets and liabilities (and remeasured at fair value every reporting period) even if they are not considered derivatives within the scope of ASC 815-10. Also, contracts that meet the conditions for classification in equity under ASC 815-40 are excluded from the scope of ASC 815-10 even if they meet the definition of a derivative.

If an equity derivative is embedded in a hybrid instrument, the guidance in ASC 815-40 will be applicable only to embedded features that meet the definition of a derivative and meet the other criteria for bifurcation. That is, if an embedded equity derivative is not clearly and closely related to the host contract, the hybrid instrument is not remeasured at fair value with changes in fair value recognized in earnings, and the embedded derivative meets the definition of a derivative in ASC 815-10, the guidance in ASC 815-40 will be relevant in the determination of whether the equity derivative needs to be bifurcated because of the scope exception in ASC 815-10, as discussed above.

10.2.6.1 ASC 815-40 — Contracts on an Entity's Own Equity

ASC 815-40 provides guidance on the accounting for contracts (and features embedded in contracts) that are indexed to, and potentially settled in, an entity's own equity (also known as contracts on own equity or equity-linked financial instruments). The analysis under ASC 815-40 can be complex; in performing this analysis, an entity often must consult with its legal counsel regarding the various terms associated with the contract. The SEC staff has noted common issues related to applying the guidance in ASC 815-40, including the following:

- Cash settlement provisions.
- Requirement to settle in registered shares.
- Insufficient number of authorized but unissued shares.
- No limit on the number of shares to be delivered.
- Incorrect conclusion regarding whether the instrument is indexed to an entity's own stock.

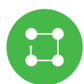
In general, a contract on an entity's own equity can be classified in equity (and not remeasured while it is classified in equity) as long as it is considered to be indexed to the entity's own stock **and** the issuer has the ability to settle the contract by issuing its own shares under all scenarios. This determination requires an evaluation of all events that could change the settlement value (e.g., adjustments to strike price) and all events that would affect the form of settlement. For additional guidance on ASC 815-40, see Deloitte's Roadmap *Contracts on an Entity's Own Equity*.

For example, as the result of a provision to adjust the conversion price (other than a standard antidilution provision that applies to all shareholders), an entity may consider an instrument not to be indexed to the issuer's own stock. This type of situation has often been problematic for entities that provide certain investors with price protection by adjusting the strike price if there is a subsequent round of equity or convertible instrument financing at a strike price that is lower than theirs. Under a provision that triggers such price protection (a "down-round provision"), the strike price would usually be adjusted to the strike price of the subsequent transaction. As a result, an instrument or embedded derivative would be accounted for as an asset or liability. However, in July 2017, the FASB issued ASU 2017-11, which makes limited changes to the guidance in ASC 815-40. In addition, ASU 2020-06, issued in August 2020, removes three of the conditions required to avoid derivative accounting, including the condition that settlement is permitted in unregistered shares. (For a discussion of new guidance on financial instruments, see Section 10.3.)

Before the adoption of ASU 2017-11, a contract (or embedded equity conversion feature) containing a down-round provision did not qualify as equity because such an arrangement precluded a conclusion that the contract was indexed to the entity's own stock under ASC 815-40-15. Therefore, freestanding contracts on an entity's own equity containing a down-round feature were accounted for at fair value, with changes in fair value recognized in earnings. Similarly, embedded equity conversion features containing down-round provisions were separated and accounted for as derivative instruments at fair value when the bifurcation criteria in ASC 815-15 were met.

ASU 2017-11 applies to issuers of financial instruments with down-round features. It amended (1) the classification of many of such instruments as liabilities by revising the guidance in ASC 815 on the evaluation of whether instruments with down-round provisions may meet the conditions to be considered indexed to the issuer's own equity and (2) the guidance on recognition and measurement of the value transferred upon the triggering of a down-round feature for equity-classified instruments by revising ASC 260.

For additional details, see Deloitte's July 21, 2017, *Heads Up*.



Connecting the Dots

If a freestanding contract on an entity's own equity does not meet the conditions for being considered indexed to the entity's own stock under ASC 815-40-15, ASC 815-40 precludes classification of the contract as equity but does not otherwise address the accounting for the contract. Accordingly, the entity should consult other accounting literature.

The long-standing position of the SEC staff is that if the contract is a written option (e.g., a warrant or call option) that does not qualify for equity classification, and the subsequent accounting is not specifically addressed in other U.S. GAAP (including ASC 480, ASC 505-50, ASC 718, ASC 805-30, and ASC 815-10), registrants should account for the contract at fair value with changes in fair value recorded in earnings in each reporting period (ASC 815-10-S99-4).

10.2.6.2 Considerations Related to Embedded Derivatives

In addition to the considerations related to freestanding instruments (e.g., warrants or stock options) under ASC 815, an entity should evaluate whether other contracts, such as those involving preferred stock or convertible debt, contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. A reporting entity identifies the terms of each embedded feature on the basis of the feature's economic payoff profile (underlying)[9] rather than on the basis of how the feature has been formally documented. In identifying the embedded features, the entity should consider all terms of the convertible instrument. Common examples of embedded features include conversion options and redemption provisions.

An identified embedded feature generally[10] must be bifurcated and accounted for separately from the host contract if the following three conditions are met:

- The embedded feature is not clearly and closely related to the host contract.
- The host instrument (e.g., preferred stock or debt) is not remeasured at fair value, with changes in fair value recognized in earnings, under other applicable GAAP.
- A separate instrument with the same terms as the embedded feature meets the definition of a derivative instrument under ASC 815-10.[11]

[9] Although there is no explicit guidance under U.S. GAAP on how to determine the unit of account for embedded features in a hybrid instrument, the approach described herein is commonly applied. Under the payoff-profile approach, each embedded derivative feature in a hybrid instrument is defined on the basis of the monetary or economic value that the feature conveys to the instrument's counterparty upon settlement. This approach is consistent with the definition of an embedded derivative in ASC 815-15-20, which focuses on the effect of an implicit or explicit term on the cash flows or values of other exchanges required under a contract. For more information on the payoff-profile approach, see Deloitte's Roadmap *Derivatives*.

[10] Subject to the scope exceptions in ASC 815-10.

[11] See ASC 815-10-15-83.

10.2.6.2.1 Clearly and Closely Related to the Host Contract

10.2.6.2.1.1 Determining the Nature of the Host Contract

When determining whether the embedded feature being analyzed is clearly and closely related to the host contract, an entity must first decide whether the nature of the host contract is more debt-like or equity-like. ASU 2014-16, issued in November 2014, clarifies that the only acceptable method for determining the nature of the host contract in a hybrid instrument issued in the form of a share is a method commonly referred to as the "whole-instrument" approach. Under the whole-instrument approach, the nature of the host contract is the same for each embedded feature being analyzed. Determining the nature of the host contract under the whole-instrument approach involves the following steps:

- Identify all of the hybrid financial instrument's stated and implied substantive terms and features.
- Determine whether the identified terms and features are more debt-like or equity-like.
- Identify the relative weight of the identified terms and features "on the basis of the relevant facts and circumstances."[12]
- Reach a conclusion about the nature of the host contract.

Further, ASC 815-15-25-17A states, in part:

> 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. [Emphasis added]

If a reporting entity is still unclear about the nature of the host contract after performing this analysis, it should consider the anticipated outcome for the holder of the hybrid financial instrument in reaching its final conclusion. Given the complexity of determining the nature of a host contract of a hybrid instrument with both conversion and redemption features, entities are encouraged to consult with their accounting advisers.

The method described above for determining the nature of the host contract applies only to hybrid instruments issued in the form of a share. A legal-form debt instrument will typically be considered to be a debt host contract.

10.2.6.2.1.2 Determining Whether the Feature Is Clearly and Closely Related to the Host Contract

Once the reporting entity has determined the nature of the host contract, it should, in accordance with ASC 815-15-25-1(a), evaluate each embedded feature separately to determine whether the economic characteristics and risks of the embedded feature are clearly and closely related to those of the host contract. If the embedded feature is clearly and closely related to the host contract, the embedded feature should not be bifurcated. If the embedded feature is not clearly and closely related to the host contract, the reporting entity must analyze the other two conditions described above to determine whether bifurcation of the embedded feature is required.

[12] See ASC 815-15-25-17C.

Commonly identified embedded features that an entity would evaluate to determine whether they are clearly and closely related to a debt or equity host contract include the following:

- *Redemption features* — A redemption feature enables the holder to receive cash to settle the equity instrument. A redemption feature may be held by the issuer or the holder and may be exercisable upon the occurrence of certain events or at any time. If an equity host contract has a redemption feature, the redemption is explicitly not considered clearly and closely related to that contract in accordance with ASC 815-15-25-20. Therefore, in such cases, an entity would need to perform additional analysis to determine whether it is required to bifurcate the redemption feature.

  Under ASC 815-15-25-42, if a debt host contract has a redemption feature, an entity must perform a four-step test to determine whether the redemption feature is clearly and closely related to the debt host.

- *Conversion features* — Conversion features enable an entity to convert an existing instrument into another form of the entity's equity (e.g., convertible preferred stock, convertible debt). ASC 815-15-25-16 indicates that a conversion feature in an equity host contract would be clearly and closely related to the equity host contract since it provides the holder with another residual interest in the same entity. Accordingly, a conversion feature in an equity host contract would not be bifurcated and accounted for separately as a derivative instrument.

  However, ASC 815-15-25-51 indicates that a conversion option in a debt host contract is not clearly and closely related to the contract. Therefore, the entity would have to perform further analysis to determine whether the other bifurcation criteria are met.

- *Changing interest/dividend rates* — Contracts may include provisions under which stated interest or dividend rates increase or decrease as a result of the occurrence or nonoccurrence of specific events. An embedded derivative that resets the interest rate of a debt host contract (i.e., a debt instrument or an equity instrument that was determined to represent a debt host) is generally clearly and closely related to the debt host if it is based on changes in interest rates,[13] the issuer's creditworthiness, or inflation. However, if, for example, an entity's bonds include a provision under which the interest rate must be reset to a different rate if an unrelated party's credit rating is downgraded at any time during the term of the bonds, the reset feature is not clearly and closely related to the debt host. An embedded derivative that changes an instrument's interest rate because of changes to the rate of inflation in the economic environment for the currency in which a debt instrument is denominated would be considered clearly and closely related to the debt host. Further, changes to an interest rate based on changes in an entity's operating performance (e.g., EBITDA) may be considered clearly and closely related to the debt host if the operating performance metric is related to the entity's creditworthiness.[14]

  Such interest rate reset provisions are generally not considered clearly and closely related to an equity host, however.

[13] See ASC 815-15-25-26.
[14] See ASC 815-15-25-46 and 25-47.

10.2.6.2.2 Separate Instrument With Same Terms Meets the Definition of a Derivative

An embedded equity derivative (e.g., a conversion option) that meets the first two conditions outlined above for bifurcating embedded equity derivatives would require further evaluation for an entity to determine whether the embedded feature should be separately accounted for as a derivative under ASC 815-10. ASC 815-10-15-83 defines a derivative as a financial instrument or other contract that (1) has an underlying as well as a notional amount or payment provision, (2) requires little or no initial net investment, and (3) can be net settled.

Equity instruments will generally meet the first and second criteria in the definition of a derivative but may not meet the third. For instance, a contract on a nonpublic entity's own stock (e.g., a warrant or stock option) may not qualify as a derivative because the entity's equity shares are not publicly traded. In such cases, unless the contract provides for net share settlement or cash settlement, the contract generally would not meet the net settlement criterion because the equity shares would not be readily convertible to cash. However, upon an IPO, the entity would need to reevaluate the contract under ASC 815 to determine whether the contract is or contains an accounting derivative now that the entity's shares are publicly traded. If the post-IPO shares or an embedded conversion feature is readily convertible to cash, the net settlement criterion would be met, resulting in an accounting derivative that may need to be recognized unless it qualifies for a scope exception to derivative accounting (discussed further below).

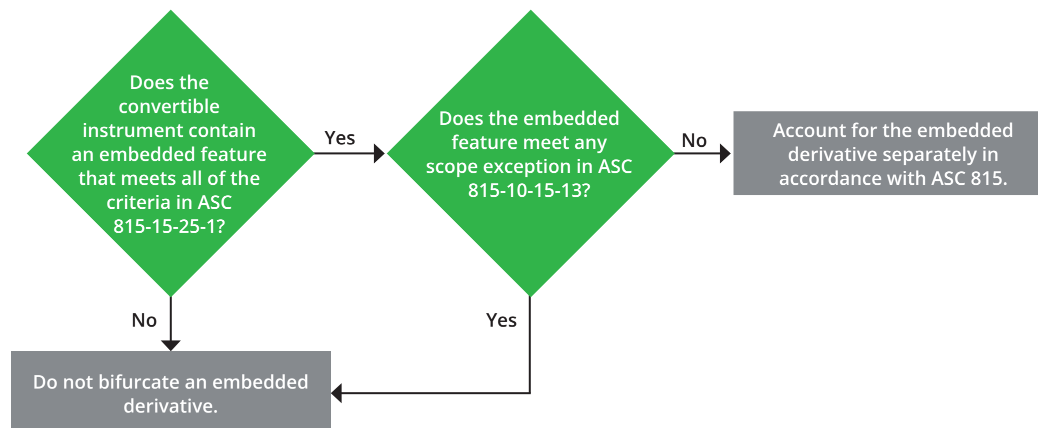
For example, a warrant to acquire common-stock shares that explicitly permits net settlement (e.g., cashless exercise) would meet the net settlement criterion. However, a warrant to acquire common-stock shares of a nonpublic entity for which gross exercise is required (i.e., the warrant holder pays the exercise price in cash to acquire common shares) would generally not meet the net settlement criterion since the contract would be settled in shares that are not readily convertible to cash. If that nonpublic entity went public, however, the warrant that previously did not meet the net settlement criterion might now satisfy the criterion since common-stock shares of a publicly traded entity are generally readily convertible to cash.

A contract that meets the definition of a derivative under the above criteria may not need to be accounted for as a derivative if it qualifies for any of the scope exceptions in ASC 815-10-15-13. One of these scope exceptions involves contracts on an entity's own equity. Generally, the value of an equity derivative is linked to the entity's own stock (i.e., the underlying of the derivative). If the derivative is indexed to the entity's own stock and would not require the entity to settle the derivative by paying cash or other assets, it would qualify for classification as equity and be outside of the scope of ASC 815.

Some equity derivatives may qualify for the scope exception in ASC 815-10-15-74(a) for certain contracts indexed to the company's own stock. If this scope exception applies, such equity derivatives would not have to be bifurcated. ASU 2020-06 removes certain conditions required for a contract to qualify for the scope exception. (For further discussion of other new guidance on financial instruments, see Section 10.3.)

However, an embedded feature that meets the definition of a derivative and does not qualify for an explicit scope exception would need to be bifurcated from the host instrument and accounted for separately as a derivative (if the other two conditions for bifurcation are also met). A bifurcated derivative (e.g., a conversion feature) would be measured initially and subsequently at fair value, with changes in fair value recognized in earnings.

The accounting for convertible debt instruments and convertible preferred stock is complex, and the SEC staff frequently asks about the classification of such instruments in entities' registration statements. The flowchart below illustrates the multistep evaluation that entities are required to perform for any hybrid instrument with a conversion feature.



10.2.6.3 *Tranche Preferred Stock Agreement*

Example 10-3

Entity X enters into a preferred stock purchase agreement with unrelated investors to sell two tranches of convertible redeemable preferred stock (the "preferred stock"). The purchase agreement stipulates the following:

- On the first closing date, which is the date of the purchase agreement, the investors will acquire 50,000 shares of preferred stock for $50 million.
- On the second closing date, the investors will acquire 25,000 additional shares of preferred stock for $25 million subject to a specified condition. The second closing will occur only if (1) a specific milestone related to X's research and clinical development is achieved two years from the first closing date or (2) the specific milestone related to X's research and clinical development is not achieved two years from the first closing date but the holders waive the milestone requirement and elect to purchase the additional shares of preferred stock (the "contingent purchase option").

The purchase agreement stipulates that the holders of preferred stock issued in the first closing cannot transfer their contingent purchase options separately from the preferred shares acquired in the first closing (or vice versa). However, such holders have the right to convert those preferred shares into common stock before the date that is two years from the first closing date. The purchase agreement does not restrict the holders that convert preferred shares into common stock from selling those common shares. The only restrictions on selling common stock stem from restrictions under U.S. securities laws.

In this example, the contingent purchase option would be considered a freestanding financial instrument because it meets the "legally detachable and separately exercisable" condition. The holders can "detach" the two instruments because they can convert the preferred stock into common stock and sell those shares while retaining the contingent purchase option (i.e., the two instruments are capable of being separated). This would be the case even if the contingent purchase option may not be separately transferred after the conversion into common stock of the preferred shares obtained in the first closing. It would not be appropriate to consider the preferred shares and the contingent purchase option a single combined financial instrument, because the contingent purchase option would not become embedded in the common shares received upon conversion of the preferred stock purchased in the first closing.

Example 10-3 (continued)

Note that the conclusion in this example would not change even if:

- The holders could not sell the common shares received upon conversion of the preferred stock purchased in the first closing before satisfaction or expiration of the contingent purchase option. At the inception of the arrangement, the two instruments still meet the legally detachable and separately exercisable condition because the contingent purchase option (1) cannot become embedded in the common shares received upon conversion of the preferred stock purchased in the first closing and (2) does not become freestanding only if the preferred stock purchased in the first closing is converted into common stock (instead, the ability to convert the preferred stock purchased in the first closing is evidence that the contingent purchase option is capable of being separated at the inception of the arrangement).
- The preferred stock purchased on the first closing date cannot be transferred or converted before the contingent purchase option is satisfied or expires and the holders have the right to acquire the additional shares related to the contingent purchase option at their option at any time before two years from the closing date. The two instruments still meet the legally detachable and separately exercisable condition because the investor can separate the two components by early exercising the contingent purchase option while retaining the preferred shares acquired on the first closing date.

As this example illustrates, and in a manner consistent with practice, an option or commitment to issue additional preferred shares is almost always a freestanding financial instrument because the separate exercisability of the option or commitment is sufficient to demonstrate that the feature is capable of being separated.

10.2.6.4 Multiple Freestanding Instruments in a Tranche Debt Issuance

Often, an entity will issue debt instruments that include tranche issuances (i.e., an initial debt issuance followed by subsequent debt issuances that are triggered by a debtor requisition right or contingent on the occurrence of certain events). It is common to see warrants contemporaneously issued to the creditor of such tranche financings as part of the transaction. These warrants may include terms such that upon the closing of the initial debt issuance, an initial warrant is issued, followed by the issuance of additional warrants upon the closing of subsequent debt issuances.

The first step in evaluating the debtor's accounting for a tranche debt arrangement with contemporaneously issued warrants is to understand whether the debt and the warrants are freestanding from one another as defined in ASC 480-10-20. As noted in Section 10.2.1, ASC 480-10-20 defines a freestanding financial instrument as a financial instrument that either (1) "is entered into separately and apart from any of the entity's other financial instruments or equity transactions" or (2) "is entered into in conjunction with some other transaction and is legally detachable and separately exercisable." Typically, aside from the tranche debt arrangement and the contemporaneous warrants, the counterparties would not enter into any other concurrent transactions. However, since these instruments would be entered into at the same time and executed on the same date, it is necessary to evaluate whether they are legally detachable and separately exercisable and, therefore, are freestanding in accordance with the second condition above. The following are common indicators that the tranche debt arrangement and the contemporaneous warrants are legally detachable and separately exercisable:

- The warrants are transferable by the creditors in whole or in part in accordance with U.S. securities law.
- The expiration date of the warrants extends beyond the maturity date of the tranche debt arrangement.
- Repayment of the tranche debt arrangement does not result in termination of the warrants.

Upon a determination that the tranche debt arrangement and the contemporaneous warrants are freestanding instruments, the next step in evaluating how to account for these instruments is to determine whether the initial debt issuance is freestanding from the commitment related to subsequent debt issuances. Since the tranche debt arrangement encompasses both the initial debt issuance and the subsequent debt issuances, they are considered to have been entered into at the same time and executed on the same date. Consequently, they should also be evaluated to determine whether they are legally detachable and separately exercisable. The following are common indicators that the initial debt issuance and the commitment related to subsequent debt issuances are legally detachable and separately exercisable:

- The creditor has the right, without the consent of or notice to the debtor, to sell, transfer, assign, negotiate, or grant participation in all or any part of, or any interest in, such creditor's obligations, rights, and benefits.
- The debtor can repay any or all of the initial debt offering/issuance and the subsequent debt offerings/issuances without affecting the terms of any other outstanding debt offerings/issuances. That is, any portion of the initial debt offering/issuance and the subsequent debt offerings/issuances can be settled without terminating the other portions of the initial debt offering/issuance and the subsequent debt offerings/issuances. This suggests that the initial debt offering/issuance and the subsequent debt offerings/issuances are separately exercisable and can "be sold or traded separately from the contract."[15]

See Example 3-2 in Section 3.3.2.1.2 of Deloitte's Roadmap ***Issuer's Accounting for Debt*** for an illustration of how to account for debt issued with additional term loan commitments from a freestanding instrument perspective.

If the debtor determines that the initial debt issuance and the subsequent debt issuances are freestanding from one another, the next step is to evaluate the initial accounting for the commitments related to subsequent debt issuances and determine whether those commitments should be accounted for as derivatives under ASC 815-10 or qualify for any derivative accounting scope exceptions. In fact, the commitments would qualify for the derivative accounting scope exception in ASC 815-10-15-69, which states, in part, that "[f]or the holder of a commitment to originate a loan (that is, the potential borrower), that commitment is not subject to the requirements of [ASC 815-10]." The subsequent debt issuances represent a commitment to originate a loan (i.e., a loan commitment), and that commitment is held by the debtor.

There is no guidance under U.S. GAAP that directly addresses a debtor's accounting for a purchased loan commitment. However, a loan commitment meets the definition of a financial asset, and the loan commitments in this case represent proceeds from the issuance of debt (i.e., the initial debt issuance) and equity-linked instruments (i.e., the warrants). Consequently, the loan commitments should be initially recognized at fair value. Generally, when a debt transaction involves both the issuance of financial instruments and the receipt of noncash financial assets (e.g., tranche debt financings that include the issuance of debt and the receipt of loan commitments), the fair value of the noncash financial assets received may be treated as part of the total proceeds received.

Regarding the mechanics of the debtor's accounting for the loan commitment, it is generally appropriate for an entity to defer fees and costs it has paid for a commitment to obtain nonrevolving debt as an asset until the related debt is drawn. The potential debtor's deferral of loan commitment costs and fees as an asset is analogous to the creditor's treatment of fees received for a loan commitment under ASC 310-20-25-11, which generally requires commitment fees to be deferred. If all or a portion of the total commitment amount is funded, a proportionate amount of the commitment asset reduces the initial net

[15] Quoted from ASC 815-10-15-5.

carrying amount of the funded debt. See Section 3.5.3.2 of Deloitte's Roadmap ***Issuer's Accounting for Debt*** for a discussion of the different methods for allocating fees/issuance costs in a bundled transaction such as this one.

The debtor is next required to determine how to account for the warrants that were issued contemporaneously with the tranche debt arrangement (under the assumption that the warrants are freestanding instruments). Note that before the issuance of the initial tranche of debt, the warrants (i.e., both the initial warrant and the additional warrants) would be viewed as one unit of account that would not qualify for equity classification since the number of shares of common stock that may be purchased under the warrants varies on the basis of debt issuances that have not yet occurred.

Once the initial debt issuance occurs, the first step in the debtor's accounting for the contemporaneously issued warrants is to determine whether the initial warrant, which is issued upon the closing of the initial debt issuance, is freestanding from the additional warrants, which are issued only upon the closings of the subsequent debt issuances. Since the warrant agreement most likely encompasses both the initial warrant and the additional warrants, all of the warrants are considered to have been entered into at the same time and executed on the same date. Consequently, the debtor should evaluate whether the initial warrant and the additional warrants are legally detachable and separately exercisable and, therefore, qualify as freestanding financial instruments under ASC 480-10-20. The following are common indicators that the initial warrant and the additional warrants are legally detachable and separately exercisable:

- The warrants are individually transferable by the warrant holders, subject to compliance with applicable federal and state securities laws. In other words, the warrants can be transferred separately from one another at the warrant holder's discretion.
- The warrant holders' choice to exercise the initial warrant does not cause the additional warrants to be automatically exercised or otherwise terminated.

Assuming that the initial warrants and the additional warrants are freestanding from one another, the debtor must determine whether the warrants should be classified as liabilities under ASC 480. ASC 480 describes three types of instruments that require liability classification:

- *Mandatorily redeemable financial instruments* — ASC 480-10-20 defines a mandatorily redeemable financial instrument as "[a]ny 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." Warrants are not financial instruments in the form of shares (i.e., while they are financial instruments that will result in the delivery of shares, they are not shares themselves). Thus, warrants typically are not mandatorily redeemable financial instruments.
- *Obligations to repurchase issuer's equity shares by transferring assets (or financial instruments indexed to such obligations)* — Most commonly, if exercised, the warrants require the debtor to issue common shares, which are not redeemable in cash other than upon an ordinary liquidation of the debtor. Accordingly, upon exercise, the warrants require the debtor to deliver its equity shares. Further, there are typically no provisions in the warrants that could require the debtor to settle the warrants in cash or other assets because each situation that would result in such a settlement of the warrants (1) is within the control of the debtor or (2) occurs when all other holders of the common units will receive (or have the right to receive) cash or other assets for their units. Accordingly, the warrants most commonly do not obligate the debtor to settle by repurchasing common units for cash or other assets.
- *Certain obligations to issue a variable number of shares* — Warrants typically do not represent a conditional obligation that must or may be settled by issuing a variable number of shares.

In light of the above, warrants on common share most commonly do not need to be classified as liabilities under ASC 480.

Next, the debtor must consider whether the warrants meet the definition of a derivative under ASC 815-10-15-83. As previously noted, ASC 815-10-15-83 defines a derivative as a financial instrument or other contract that (1) has an underlying as well as a notional amount or payment provision, (2) requires little or no initial net investment, and (3) can be net settled. Typically:

- Warrants have an underlying (the fair value of the debtor's common stock) and a notional amount (the number of shares of common stock issuable).
- Warrants require an initial net investment that is less, by more than a nominal amount, than the initial net investment that would be required to acquire the number of shares of common stock into which the warrants are exercisable.
- Warrant holders can elect net share settlement by cashless exercise.

In light of the above, warrants most commonly possess all three characteristics of a derivative.

Assuming that the initial warrant and the additional warrants meet the definition of a derivative, the debtor must then determine whether those warrants qualify for the equity scope exception in ASC 815-10-15-74(a), which states that contracts issued or held by a reporting entity that are both indexed to its own stock and classified in stockholders' equity in its statement of financial position are not considered to be derivative instruments under ASC 815.

Often, in arrangements in which warrants are issued contemporaneously with tranche debt arrangements, the initial warrant will be considered to be indexed to the debtor's own stock since it is (1) issued and outstanding immediately as of the execution of the arrangement (i.e., upon the closing of the initial debt issuance) and (2) exercisable for a fixed number of shares of common stock at a fixed exercise price (i.e., a fixed-for-fixed forward or option under ASC 815-40-15-7E). In addition, the initial warrant is likely meet the conditions for equity classification under ASC 815-40-25. Accordingly, the initial warrant typically will qualify for the equity scope exception and be classified in the debtor's equity rather than as a derivative liability.

Conversely, the additional warrants will not be considered to be indexed to the debtor's own stock since the number of shares of common stock that may be purchased under the additional warrants varies on the basis of the amount of subsequent debt issuances that occur after funding of the initial debt issuance. Because subsequent debt issuances do not represent an input into the pricing of a fixed-for-fixed option on equity shares under ASC 815-40-15-7E, the additional warrants are not considered to be indexed to the debtor's stock and must be classified as derivative liabilities and initially measured, and subsequently remeasured, at fair value with changes in fair value recognized in earnings in accordance with ASC 815-10-35-1. Upon the occurrence of subsequent debt issuances, the additional warrants associated with such issuances would become fixed for fixed under ASC 815-40-15-7E in the same way as the initial warrant, as described above. Accordingly, as soon as the additional warrants qualify as fixed for fixed, they will be reclassified from derivative liabilities to equity instruments.

10.2.6.5 Standby Equity Purchase Agreements

Financial instruments known as standby equity purchase agreements (SEPAs) have become more common in the life sciences industry as industry participants look for additional ways to provide liquidity while avoiding exposure to rising interest rates. A SEPA is an equity-linked instrument for which the issuing entity has the right, but not the obligation, to sell the entity's common stock to third-party investors over a specified period. In exchange for its access to capital through the SEPA, the entity typically provides up-front consideration to the investor in the form of cash or shares of the entity's common stock. Economically, before the entity has elected to sell shares, a SEPA represents a purchased put option on the entity's own equity. However, once the entity "draws" on the SEPA, the related number of shares issuable constitutes a forward contract to issue common stock. Thus, SEPAs contain both a purchased put option element and a forward share issuance element. Generally, neither element qualifies for equity classification under ASC 815. See Section 6.2.5 of Deloitte's Roadmap *Contracts on an Entity's Own Equity* for a detailed description of an issuer's accounting for a SEPA.

Note that in practice, SEPAs may also be referred to as common stock purchase agreements or equity lines of credit (ELOCs).

10.2.7 Fair Value

Many Codification topics require or permit the subsequent measurement of assets or liabilities at fair value. ASC 820-10-35 provides guidance on the subsequent measurement of items at fair value and applies to both recurring and nonrecurring measurements. The definition of fair value is based on an exit price notion. An asset, liability, or equity instrument is measured at fair value on the basis of market-participant assumptions; such measurement is not entity-specific. Entities must consider all characteristics of the asset, liability, or equity instrument that a market participant would consider in determining an exit price in the principal or most advantageous market.

10.2.7.1 Restrictions on the Sale or Use of an Asset

In some cases, it is appropriate to consider a restriction on the sale or use of an asset as a characteristic of the asset that affects its fair value. Only a legal or contractual restriction on the sale or use of an asset that is specific to the asset (an instrument-specific restriction) and that would be transferred to market participants should be incorporated into the asset's fair value measurement. Thus, an entity should consider the effect of a restriction on the sale or use of an asset that it owns only if market participants would consider such a restriction in pricing the asset because they would also be subject to the restriction if they acquired the asset. Entity-specific restrictions that would not be transferred to market participants should not be considered in the determination of the asset's fair value, since doing so would be inconsistent with the exit price notion underlying the definition of fair value. The table below gives examples of restrictions on the sale of assets and addresses whether they are instrument-specific or entity-specific.

Examples of Restrictions on the Sale of Assets		
Nature of Restriction	**Description of Restriction**	**Impact of Restriction on Fair Value**
Restriction on the sale of securities offered in a private offering in accordance with Rule 144 of the Securities Act of 1933 ("Securities Act Rule 144") or similar rules (private placements)	Securities Act Rule 144 legally restricts the sale of certain securities to buyers that meet specified criteria.	As discussed in ASC 820-10-55-52, this type of restriction is a characteristic of the security and would be transferred to market participants. Therefore, the fair value measurement of the security should take this instrument-specific restriction into account. An instrument-specific restriction on a security affects a fair value measurement by the amount that a market participant would demand because of the inability to access a public market for the security for the specified period. As discussed in ASC 820-10-55-52, that amount depends on the nature and duration of the restriction, the extent to which buyers are limited by the restriction, and qualitative and quantitative factors specific to both the instrument and the issuer. Quoted prices for such securities would reflect the resale restriction; therefore, there should be no further adjustment to reflect the restriction.
Founder's shares in an IPO of equity securities	Founders may be contractually restricted from selling their shares for a period after an IPO. Such restrictions may be outlined in the IPO prospectus.	If this restriction is not embedded in the contractual terms of the shares (which it generally is not) and thus would not be transferred in a hypothetical sale of the shares, the restriction is specific to the founders and not a characteristic of the security. Therefore, the founders should not consider this restriction in determining fair value. Note that in June 2022, the FASB issued ASU 2022-03, which improves financial reporting for investors and other financial statement users by increasing comparability of financial information across reporting entities that have investments in equity securities measured at fair value that are subject to contractual restrictions preventing the sale of those securities.

(Table continued)

Examples of Restrictions on the Sale of Assets		
Nature of Restriction	**Description of Restriction**	**Impact of Restriction on Fair Value**
Security sale restriction related to a seat on the board of directors	An entity (Entity A) has an equity investment in another entity (Entity B) and is represented on its board of directors. Because officers of A are directors of B, A is restricted from selling any of its investment securities in B during each period that is two weeks before the end of each quarter through 48 hours after B's earnings are released (also referred to as a "blackout period").	Other market participants would not face this restriction. Because the restriction is entity-specific (i.e., it is not a characteristic of the security) and would not be transferred with the security, an entity should not consider the restriction in measuring the security at fair value.
Assets pledged as collateral	An entity has a borrowing arrangement in which assets must be pledged as collateral.	Other market participants would not face this restriction. Because the restriction is entity-specific (i.e., it is not a characteristic of the assets) and would not be transferred with the assets, an entity should not consider the restriction in measuring the assets at fair value.

The determination of whether a contractual or legal restriction on the sale or use of an asset is instrument-specific or entity-specific is sometimes straightforward; other times, an entity may need to exercise judgment or consult a legal specialist in making this determination.

10.2.7.2 Premiums or Discounts Based on Size of a Position

ASC 820-10-35-36B addresses when a fair value measurement should include a premium or discount as a result of the size of an asset, liability, or instrument classified in an entity's stockholders' equity. In a manner consistent with the guidance on transfer restrictions (see above), a fair value measurement includes a premium or discount that reflects the size of the item only if size is a characteristic of the asset, liability, or instrument classified in stockholders' equity. A fair value measurement cannot include "[p]remiums or discounts that reflect size as a characteristic of the . . . entity's holding" (i.e., a blockage factor) rather than as a characteristic of the asset, liability, or instrument classified in stockholders' equity that is determined on the basis of its unit of account under other Codification topics (e.g., a control premium or minority interest discount that is appropriate on the basis of its unit of account). ASC 820-10-35-36B indicates that when "there is a quoted price in an active market . . . for an asset or a liability" (i.e., a Level 1 input), an entity must "use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C." However, even if a fair value measurement is categorized within Level 2 or Level 3 of the fair value hierarchy in its entirety, the fair value measurement cannot include a premium or discount for size (e.g., a blockage factor) when this premium or discount results from the size of an entity's holding rather than from a characteristic of the item being valued.

10.2.7.2.1 Blockage Factors

As described in ASC 820-10-35-36B, a blockage factor represents a discount that "adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity." The basic principle in ASC 820-10-35-36B is that blockage factors are prohibited at all levels of the fair value hierarchy. An adjustment to a quoted price of an individual asset or liability to reflect a blockage factor is not permitted under ASC 820 when the unit of account for the asset or liability is the individual instrument (i.e., the unit of account for the holding under U.S. GAAP is aligned with the unit of account related to the quoted price). For example, if an entity holds a large position in a publicly traded common stock and would expect to sell the position in a single transaction (i.e., a large block), the price it would receive would reflect a discount to the product of the quoted market price and the number of shares held; however, that discount should not be reflected in a fair value measurement because it reflects the size of the entity's holding as opposed to a characteristic of the asset held.

However, if the unit of account for fair value measurement purposes is the entire holding (i.e., entire position), an adjustment to reflect the size of the holding may be appropriate. Further, if the unit of valuation reflects the entire holding, an adjustment to reflect the size of the holding may be appropriate even if the unit of account differs from the unit of valuation and application of a blockage factor at the unit-of-account level would be inappropriate. Thus, a discount that adjusts a quoted price of an asset or liability to reflect a blockage factor could, in certain circumstances, be consistent with the definition of fair value in ASC 820.

10.3 New Accounting Standards

10.3.1 Impairment (ASUs 2016-13, 2019-04, 2019-05, 2019-10, 2019-11, 2020-03, 2022-01, and 2022-02)

10.3.1.1 Background

In June 2016, the FASB issued ASU 2016-13 (the "new credit losses standard," codified in ASC 326), which amends guidance on the impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model (known as the current expected credit loss [CECL] model) that is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses, which is presented as either (1) an offset to the amortized cost basis of the related asset (for on-balance-sheet exposures) or (2) a separate liability (for off-balance-sheet exposures). That is, the expected credit losses estimated over the lifetime of a financial instrument are recognized at inception (i.e., on day 1).

Key provisions of ASU 2016-13 are discussed below. For more information about the new credit losses standard, see Deloitte's Roadmap *Current Expected Credit Losses*.

10.3.1.2 The CECL Model

10.3.1.2.1 Scope

The CECL model applies to most[16] debt instruments (other than those measured at fair value), trade receivables, net investments in leases, reinsurance receivables that result from insurance transactions,

[16] The following debt instruments would not be accounted for under the CECL model:
- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of an NFP.
- Loans and receivables between entities under common control.

financial guarantee contracts,[17] and loan commitments. However, available-for-sale (AFS) debt securities are excluded from the model's scope and will continue to be assessed for impairment under the guidance in ASC 320 (the FASB moved the impairment model for AFS debt securities from ASC 320 to ASC 326-30 and has made limited amendments to the impairment model for AFS debt securities).

10.3.1.2.2 Recognition of Expected Credit Losses

Unlike the incurred loss models in legacy U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity will recognize its estimate of expected credit losses for financial assets as of the end of the reporting period. Credit impairment will be recognized as an allowance — or contra-asset — rather than as a direct write-down of a financial asset's amortized cost basis. However, the carrying amount of a financial asset that is deemed uncollectible will be written off in a manner consistent with legacy U.S. GAAP.

10.3.1.2.3 Measurement of Expected Credit Losses

ASU 2016-13 describes the impairment allowance as a "valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset." An entity can use various measurement approaches to determine the impairment allowance. Some approaches project future principal and interest cash flows (i.e., a discounted cash flow method), while others project only future principal losses. Regardless of the measurement method used, an entity's estimate of expected credit losses should reflect the losses that occur over the contractual life of the financial asset.

When determining the contractual life of a financial asset, an entity is required to consider expected prepayments either as a separate input in the method used to estimate expected credit losses or as an amount embedded in the credit loss experience that it uses to estimate such losses. The entity is not allowed to consider expected extensions of the contractual life unless (1) extensions are a contractual right of the borrower or (2) the entity has a reasonable expectation as of the reporting date that it will execute a troubled debt restructuring (TDR) with the borrower.[18]

An entity must consider all available relevant information when estimating expected credit losses, including details about past events, current conditions, and reasonable and supportable forecasts. That is, while an entity can use historical charge-off rates as a starting point for determining expected credit losses, it must evaluate how conditions that existed during the historical charge-off period may differ from its current expectations and revise its estimate of expected credit losses accordingly. However, the entity is not required to forecast conditions over the entire contractual life of the asset. Rather, for the period beyond that for which the entity can make reasonable and supportable forecasts, the entity should revert to historical credit loss experience.

10.3.1.2.4 Unit of Account

The CECL model does not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity is required to evaluate financial assets within the scope of the model on a collective (i.e., pool) basis when assets share similar risk characteristics. If a financial asset's risk characteristics are not similar to those of any of the entity's other financial assets, the entity would evaluate that asset individually. If the financial asset is individually

[17] The CECL model does not apply to financial guarantee contracts that are accounted for as insurance or measured at fair value through net income.

[18] ASU 2022-02, issued in March 2022, eliminates the concept of a TDR from a creditor's accounting. As a result, an entity that has adopted ASU 2022-02 will no longer be able to extend the contractual term for expected extensions, renewals, and modifications when it reasonably expects, as of the reporting date, that a TDR will be executed with the borrower.

evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

10.3.1.2.5 Write-Offs

In a manner similar to legacy guidance, ASU 2016-13 requires an entity to write off the carrying amount of a financial asset when the asset is deemed uncollectible. However, unlike legacy guidance, the ASU's write-off guidance also applies to AFS debt securities.

10.3.1.2.6 Application of the CECL Model to Trade Receivables

Receivables that result from revenue transactions under ASC 606 are subject to the CECL model. ASU 2016-13 includes the following example illustrating how an entity could use a provision matrix to apply the guidance to trade receivables:

ASC 326-20

Example 5: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule

55-37 This Example illustrates one way an entity may estimate expected credit losses for trade receivables using an aging schedule.

55-38 Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 percent discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

a. 0.3 percent for receivables that are current
b. 8 percent for receivables that are 1–30 days past due
c. 26 percent for receivables that are 31–60 days past due
d. 58 percent for receivables that are 61–90 days past due
e. 82 percent for receivables that are more than 90 days past due.

55-39 Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects there will be an additional decrease in unemployment over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

ASC 326-20 (continued)

55-40 At the reporting date, Entity E develops the following aging schedule to estimate expected credit losses.

Past-Due Status	Amortized Cost Basis	Credit Loss Rate	Expected Credit Loss Estimate
Current	$ 5,984,698	0.27%	$ 16,159
1–30 days past due	8,272	7.2%	596
31–60 days past due	2,882	23.4%	674
61–90 days past due	842	52.2%	440
More than 90 days past due	1,100	73.8%	812
	$ 5,997,794		$ 18,681

Connecting the Dots

The example above from ASU 2016-13 illustrates that an entity's use of a provision matrix to apply the CECL model to trade receivables may not differ significantly from its methods under legacy guidance for determining the allowance for doubtful accounts. However, the example also shows that when using such a matrix, the entity is required to consider the following:

- Whether expected credit losses should be recognized for trade receivables that are considered "current" (i.e., not past due). In the example above, a historical loss rate of 0.3 percent is adjusted to 0.27 percent on the basis of the current and reasonable and supportable forecasted economic conditions and is applied to the trade receivables that are classified as current. This may be a change from practice under legacy guidance for many life sciences companies.
- When using historical loss rates in a provision matrix, the entity must assess whether and, if so, how the historical loss rates differ from what is currently expected over the life of the trade receivables (on the basis of current conditions and reasonable and supportable forecasts).

10.3.1.3 Technical Corrections and Amendments

Since the release of ASU 2016-13, the FASB has issued ASUs 2019-04, 2019-05, 2019-10, 2019-11, 2020-03, 2022-01, and 2022-02 to provide various technical corrections and amendments to the guidance on credit losses in ASC 326. For an in-depth discussion of those technical corrections and amendments, see Deloitte's Roadmap *Current Expected Credit Losses*.

10.3.2 Hedge Accounting (ASUs 2017-12, 2019-04, 2019-10, and 2022-01)

10.3.2.1 Background

In August 2017, the FASB issued ASU 2017-12, which amends the hedge accounting recognition and presentation requirements in ASC 815. The Board's objectives in issuing the ASU were to (1) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities and (2) reduce the complexity, and simplify the application, of hedge accounting by preparers. However, as a result of subsequent stakeholder feedback

on the ASU, the FASB decided to make certain Codification improvements, some of which the Board incorporated into ASU 2019-04.

10.3.2.2 Key Changes to the Hedge Accounting Model

ASU 2019-04 clarifies various aspects of ASU 2017-12, including its guidance on the following:

- Certain aspects of partial-term fair value hedges of interest rate and foreign exchange risk.
- The amortization period for fair value hedge basis adjustments.
- Disclosure requirements for fair value hedge basis adjustments when the hedged item is an AFS debt instrument.
- Consideration of the hedged contractually specified interest rate for measuring hedge effectiveness for a cash flow hedge when the hypothetical derivative method is used.
- Application of a first-payments-received cash flow hedging technique to overall cash flows on a group of variable interest payments.
- The requirements for NFPs related to the treatment of an excluded component in a fair value hedge.
- The transition relief provided for certain NFPs.
- Transition for all entities.

10.3.2.3 Effective Date and Transition

As noted in ASU 2019-04, "[f]or entities that have not yet adopted the amendments in Update 2017-12 as of the issuance date of this Update, the effective dates and transition requirements for the amendments to Topic 815 are the same as the effective dates and transition requirements in Update 2017-12." See Section 10.3.2.4 below.

For entities that have adopted ASU 2017-12, ASU 2019-04 is effective "as of the beginning of the first annual reporting period beginning after the date of issuance of Update 2019-04." Those entities may early adopt ASU 2019-04 at any time after its issuance.

For more information about ASU 2019-04, see Deloitte's May 7, 2019, ***Heads Up***.

10.3.2.4 Changes to Effective Dates

In November 2019, the FASB issued ASU 2019-10, which (1) provides a framework to stagger effective dates for future major accounting standards and (2) gives private companies, NFPs, and certain small public companies additional time to implement the FASB's major standards on credit losses, leasing, and hedging. For more information about ASU 2019-10, see Deloitte's November 19, 2019, ***Heads Up***.

10.3.2.5 Implementation Developments

The FASB is continuing its efforts to improve ASU 2017-12. For example, in November 2019, the Board issued a proposed ASU that would clarify certain aspects of the ASU, including (1) changes in hedged risk in a cash flow hedge, (2) contractually specified components in cash flow hedges of nonfinancial forecasted transactions, (3) foreign-currency-denominated debt instruments designated as hedging instruments and hedged items, and (4) use of the term "prepayable" under the shortcut method. The comment period for the proposed ASU ended on January 13, 2020.

In March 2022, the FASB issued ASU 2022-01, which clarifies the guidance in ASC 815 on fair value hedge accounting of interest rate risk for portfolios of financial assets. The ASU amends the guidance in ASU 2017-12 that, among other things, established the last-of-layer method for making the fair value hedge accounting for these portfolios more accessible. ASU 2022-01 renames that method the "portfolio layer" method and addresses feedback from stakeholders regarding its application. For more information about ASU 2022-01, see Deloitte's March 29, 2022, *Heads Up*.

10.3.3 Clarifying the Interactions Between ASC 321, ASC 323, and ASC 815 (ASU 2020-01)

In January 2020, as a result of subsequent stakeholder feedback on ASU 2016-01, the FASB issued ASU 2020-01, which clarifies the interactions between (1) the accounting for equity securities under ASC 321, (2) the accounting for investments under the equity method in accordance with ASC 323, and (3) the accounting for certain forward contracts and purchased options under ASC 815. The amendments in ASU 2020-01 include the following provisions:

- Immediately before applying or upon discontinuing the equity method of accounting, an entity that applies the ASC 321 measurement alternative should consider observable transactions that require it to either apply or discontinue the equity method.
- In applying ASC 815-10-15-141(a), an entity should not consider whether, upon the settlement of a forward contract or exercise of a purchased option, the underlying securities individually or with existing investments would be accounted for under the equity method in accordance with ASC 323 or the fair value option in accordance with the financial instruments guidance in ASC 825. However, the entity should evaluate the remaining characteristics in ASC 815-10-15-141 to determine the accounting for its forward contracts and purchased options.

For more information, see Deloitte's November 2019 *EITF Snapshot*.

10.3.3.1 Effective Date and Transition

ASU 2020-01 is effective for PBEs for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years.

Early adoption is permitted, including in an interim period. ASU 2020-01 should be applied prospectively.

10.3.4 Reference Rate Reform (ASU 2020-04)

10.3.4.1 Background

In response to the market-wide migration away from the London Interbank Offered Rate (LIBOR) and other interbank offered rates, the FASB initiated a project on reference rate reform. The Board held several meetings in 2019 to discuss the project and to consider hedge accounting relief and broader transition implications.

As a result of the meetings, in March 2020, the FASB issued ASU 2020-04. The relief provided by the ASU (in ASC 848, added by the ASU) is elective and applies "to all entities, subject to meeting certain criteria, that have contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued because of reference rate reform." The ASU establishes a general contract modification principle that entities can apply in other areas that may be affected by reference rate reform, as well as (1) elective contract modification expedients for specific areas of the Codification, (2) certain elective hedge accounting expedients, and (3) held-to-maturity debt security classification relief. See below for further information.

The FASB is not acting alone in its efforts to address issues related to reference rate reform. In July 2019, the SEC staff issued a statement that provides additional guidance related to reference rate reform. For more information about the staff's statement, see Deloitte's August 6, 2019, *Heads Up*.

10.3.4.2 Contract Modifications

The elective guidance in ASU 2020-04 applies to modifications of contract terms that will directly replace, or have the potential to replace, an affected rate with another interest rate index, as well as certain contemporaneous modifications of other contract terms related to the replacement of an affected rate. When contemporaneous modifications are made, an entity's eligibility to use the relief provided by ASC 848-20 (added by the ASU) depends on whether the contemporaneous modifications to the other terms (1) could affect the amount or timing of contractual cash flows and (2) are related to reference rate reform.

The table below summarizes the optional expedients provided by the ASU for specific areas of the Codification that an entity could elect to apply to qualifying contract modifications.

Codification Topic	Optional Expedients
Receivables (ASC 310)	Account for the modification as if it were only minor (and not an extinguishment) in accordance with ASC 310-20-35-10.
Debt (ASC 470)	Account for the modification as if it were not substantial (i.e., do not treat as an extinguishment). In applying the 10 percent cash flow test in ASC 470-50-40-10 for any subsequent contract modifications made within a year, entities should consider only terms and provisions that were in effect immediately following the election of the optional expedient.
Leases (ASC 840 or ASC 842)	The modification will not (1) trigger reassessment of lease classification and the discount rate or (2) require the entity to remeasure lease payments or perform the other reassessments or remeasurements that would otherwise be triggered by a modification under ASC 840 or ASC 842 when that modification is not accounted for as a separate contract. The modification of terms on which variable lease payments depend will not cause the lessee to remeasure the lease liability. The effects of such changes will instead be recognized in profit or loss in the period in which the obligation for those payments is incurred.
Embedded derivatives (ASC 815-15)	The modification of the contract terms will not cause an entity to reconsider its conclusion about whether that contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract.
Other contracts	Account for the modification "as an event that does not require contract remeasurement at the modification date or reassessment of a previous accounting determination required under the relevant Topic or Industry Subtopic."

10.3.4.3 Hedging Relationships

ASU 2020-04 also allows entities to amend their formal designation and documentation of hedging relationships in certain circumstances as a result of reference rate reform. Under the ASU, if specified criteria are met, entities may change certain critical terms of existing hedging relationships that are affected or expected to be affected by reference rate reform, and these changes would not, in and of themselves, cause an entity to dedesignate the hedging relationship. An entity may elect to apply (1) expedients related to hedge accounting to each individual hedging relationship (and not necessarily to other similar hedging relationships) and (2) multiple optional expedients for a single hedging relationship and in different reporting periods.

When an entity elects to apply an expedient, it must update its hedge documentation to note any changes. Hedge documentation must be updated no later than when the entity performs its first hedge effectiveness assessment after the change is made in accordance with ASC 815.

10.3.4.3.1 Fair Value Hedges

For existing hedges, an entity may change the designated benchmark interest rate and the component of cash flows if (1) the rate referenced by the hedging instrument changes or (2) the designation of the hedging instrument is changed to a combination of derivatives. Further, (1) the benchmark interest rate designated at hedge inception should be an affected rate, (2) the newly designated rate should be an eligible benchmark interest rate, and (3) the entity must expect that the hedging relationship will be highly effective prospectively.

Further, for existing hedges for which the shortcut method is applied, when an entity assesses whether the hedging relationship continues to meet the shortcut criteria, it can, for the remainder of the hedging relationship (including for periods after December 31, 2022), disregard the requirements that (1) the formula for computing net settlements under the interest rate swap is the same for each net settlement and (2) the hedging relationship does not contain any atypical terms or terms that would invalidate an assumption of perfect effectiveness.

10.3.4.3.2 Cash Flow Hedges

If the designated hedged risk in a cash flow hedge of a forecasted transaction is an affected rate, an entity can continue to assert that the forecasted transaction's occurrence is probable despite the entity's expectations about the reference rate's discontinuance; however, the entity must continue to assess whether it is probable that the underlying forecasted transaction (e.g., future interest payments) will occur.

Further, if an entity applies the change in hedged risk guidance to a hedging relationship affected by reference rate reform, it may determine that the hedging relationship can continue by electing an optional expedient method to assess hedge effectiveness.

ASU 2020-04 also notes that if a forecasted transaction in a hedged group of forecasted transactions references an affected rate, the entity may disregard the requirement that the group of individual transactions share the same risk exposure for which they are designated as being hedged; however, the other requirements for hedging a group of forecasted transactions still must be met (e.g., forecasted purchases cannot be combined in a group with forecasted sales).

The ASU allows entities to apply certain optional expedients to change a cash flow hedging relationship's critical terms in certain circumstances. It provides additional cash flow hedge expedients that offer relief to entities when they perform effectiveness assessments for new or existing cash flow hedging relationships in which either the hedged forecasted transaction or the hedging instrument references an affected rate. These expedients allow an entity to ignore certain requirements that a hedging relationship would have otherwise been required to satisfy to qualify for application of the specified method of assessing hedge effectiveness. For existing hedging relationships, an entity should apply the optional practical expedient prospectively from the date on which it first applies the expedient. An entity would use the expedient for both prospective and retrospective effectiveness assessments (retrospective assessments would go back only to the date on which the entity first applied the expedient). An entity that elects to apply an expedient must also amend its hedge documentation to reflect its new effectiveness assessment method.

10.3.4.4 Held-to-Maturity Debt Securities

Under ASU 2020-04, an entity may make a one-time election to sell, or to transfer to the AFS or trading classifications (or both sell and transfer), debt securities that both (1) reference an affected rate and (2) were classified as held to maturity before January 1, 2020. An entity that makes this election is not required to apply it to all debt securities meeting these criteria. Such sales or transfers would not call into question the entity's previous assertions about its intent and ability to hold those securities to maturity. An entity making such a transfer is required to apply the measurement guidance governing transfers in ASC 320-10-35-10 through 35-16 and provide the disclosures required by ASC 320-10-50-10.

10.3.4.5 Effective Date and Transition

Originally, the FASB provided that the optional amendments in ASU 2020-04 are effective for all entities as of March 12, 2020, through December 31, 2022. However, in December 2022, the FASB issued ASU 2022-06 to defer the sunset date of ASC 848 until December 31, 2024. Accordingly, the optional amendments in ASU 2020-04, as amended by ASU 2022-06, are effective for all entities as of March 12, 2020, through December 31, 2024, as shown in the table below.

Type	Effective Date/Expiration Date
Contract modifications	• The amendments are effective for eligible contract modifications by topic and industry subtopic in accordance with either of the following: ◦ As of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020. ◦ Prospectively from a date within an interim period that includes or is subsequent to March 12, 2020, up to the date that the financial statements are available to be issued. • The amendments do not apply to contract modifications made after December 31, 2024.

(Table continued)

Type	Effective Date/Expiration Date
Hedging relationships	• The amendments are effective for either of the following eligible hedging relationships: ◦ Those existing as of the beginning of the interim period that includes March 12, 2020. ◦ Those entered into after the beginning of the interim period that includes March 12, 2020. • The amendments do not apply to either of the following: ◦ New hedging relationships entered into after December 31, 2024. ◦ Hedging relationships evaluated for periods after December 31, 2024.[19]
Sale or transfer of held-to-maturity securities	The one-time election to sell or transfer eligible held-to-maturity securities may be made at any time after March 12, 2020, but no later than December 31, 2024.

Connecting the Dots

In January 2021, the FASB issued ASU 2021-01, which refines the scope of ASC 848 and clarifies some of its guidance as part of the Board's monitoring of global reference rate reform activities. The ASU permits entities to elect certain optional expedients and exceptions when accounting for derivative contracts and certain hedging relationships affected by changes in the interest rates used for discounting cash flows, for computing variation margin settlements, and for calculating price alignment interest in connection with reference rate reform activities under way in global financial markets. For more information, see Deloitte's January 11, 2021, *Heads Up*. Note, however, that the guidance in ASU 2021-01 is amended to the extent that ASU 2022-06 defers the sunset date of ASC 848 until December 31, 2024.

For more information about ASU 2020-04, see Deloitte's March 23, 2020, *Heads Up*. For more information about ASU 2022-06, see Deloitte's December 21, 2022, *Heads Up*.

10.3.5 Simplifying the Accounting for Convertible Instruments and Contracts on an Entity's Own Equity (ASU 2020-06)

10.3.5.1 Background

As noted in Section 10.2.4, in August 2020, the FASB issued ASU 2020-06, which simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity's own equity. In addition, the ASU affects the diluted EPS calculation for (1) instruments that may be settled in cash or shares and (2) convertible instruments.

[19] Under ASU 2020-04, as amended by ASU 2022-06, if any of the following expedients are elected for hedging relationships existing as of December 31, 2024, they will be retained through the end of the hedging relationship:
- "An optional expedient to the systematic and rational method used to recognize in earnings the components excluded from the assessment of effectiveness."
- "An optional expedient to the rate to discount cash flows associated with the hedged item and any adjustment to the cash flows for the designated term or the partial term of the designated hedged item in a fair value hedge."
- "An optional expedient to not periodically evaluate [the specified] conditions in [ASC] 815-20-25-104(d) and (g) when using the shortcut method for a fair value hedge."

10.3.5.2 Convertible Instruments

There are currently five accounting models in ASC 470-20 for the allocation of proceeds attributable to the issuance of a convertible debt instrument. The table below outlines those models and their status under ASU 2020-06.

Instrument	Allocation Approach	Allocation Objective	Approach Retained Under ASU 2020-06?
Convertible instrument with a bifurcated embedded derivative	With-and-without method. The embedded derivative is measured first at fair value, and the residual amount is allocated to the host contract.	To measure the embedded derivative at fair value in a manner similar to how a freestanding derivative instrument is measured	Yes
Traditional convertible debt	No separation. All proceeds are recorded as debt.	To reflect the mutual exclusivity of debt repayment and conversion option exercise (i.e., both cannot happen)	Yes
Convertible debt issued at a substantial premium	With-and-without method. The debt is measured first at its principal amount, and the residual amount is allocated to equity.	To record a substantial premium received in equity	Yes
Convertible debt with a CCF	With-and-without method. The nonconvertible debt component is measured first at its fair value, and the residual amount is allocated to equity.	To reflect interest cost that is paid with the conversion feature	No
Convertible instrument with a BCF	With-and-without method. The BCF is measured first at its intrinsic value and allocated to equity, and the residual amount is allocated to the host contract.	To record the intrinsic value of the conversion feature in equity	No

As the table above notes, ASU 2020-06 removes from U.S. GAAP the separation models for (1) convertible debt with a CCF and (2) convertible instruments with a BCF. As a result, after adopting the ASU's guidance, entities will not separately present in equity an embedded conversion feature in such debt. Instead, they will account for a convertible debt instrument wholly as debt, and for convertible preferred stock wholly as preferred stock (i.e., as a single unit of account), unless (1) a convertible instrument contains features that require bifurcation as a derivative under ASC 815 or (2) a convertible debt instrument was issued at a substantial premium.

Connecting the Dots

Under current guidance, applying the separation models in ASC 470-20 to convertible instruments with a BCF or CCF involves the recognition of a debt discount, which is amortized to interest expense. The elimination of these models will reduce reported interest expense and increase reported net income for entities that have issued a convertible instrument that was within the scope of those models before the adoption of ASU 2020-06.

For an in-depth discussion of the application of the separation models in ASC 470-20, see Deloitte's Roadmap *Convertible Debt (Before Adoption of ASU 2020-06)*.

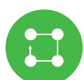
10.3.5.3 Contracts on an Entity's Own Equity

Under current U.S. GAAP, a freestanding contract on an entity's own equity (e.g., a warrant) is accounted for as an asset or a liability unless it (1) is considered to be indexed to the entity's own equity under ASC 815-40-15 and (2) meets the equity classification conditions in ASC 815-40-25, in which case it is accounted for as equity.

For a contract to qualify for equity classification under ASC 815-40-25, it must require or permit the issuing entity to share settle it (either physically or net in shares). Any provision that could require the issuer to net cash settle the contract precludes equity classification with limited exceptions. For an entity to conclude that it cannot be required to net cash settle a contract, the entity must ensure that the equity classification conditions in ASC 815-40-25 are met. Existing guidance includes seven other conditions that address whether there are any circumstances under which the issuer could be forced to net cash settle the contract given the contract's terms and the regulatory and legal framework.

ASU 2020-06 removes from ASC 815-40-25-10 three of the conditions that currently must be met to avoid derivative accounting: (1) the ability to deliver unregistered shares upon settlement, (2) neither party is required to post collateral, and (3) certain counterparty rights. In addition, the ASU clarifies that the condition regarding failure to timely file with the SEC does not preclude equity classification when an instrument requires penalty payments for such failure.

Further, ASU 2020-06 requires freestanding contracts on an entity's own equity that do not qualify as equity under ASC 815-40 to be accounted for at fair value, with changes in fair value recognized in earnings, irrespective of whether such contracts meet the definition of a derivative in ASC 815.



Connecting the Dots

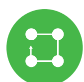
The FASB decided not to proceed with proposed amendments that would have (1) added a remote-likelihood threshold to the indexation and classification guidance in ASC 815-40 and (2) changed the reassessment frequency. Instead, it has added to its agenda a separate project to explore improvements to this guidance.

10.3.5.4 Earnings per Share

ASU 2020-06 provides the following clarifications to improve the consistency of EPS calculations:

- Entities must apply the if-converted method to all convertible instruments; the treasury stock method is no longer available.
- If the financial instrument can be settled in shares or cash, an entity must presume that the instrument will be settled in shares when calculating diluted EPS. ASU 2020-06 removes an entity's ability to rebut the presumption of share settlement, thus affecting the diluted EPS calculation for both convertible instruments and contracts on an entity's own equity.

- ASU 2020-06 extends the scope of the recognition and measurement guidance in ASC 260 on financial instruments that include down-round features to include equity-classified convertible preferred stock that contains such features. If the down-round feature is triggered, its effect "is treated as a dividend and as a reduction of income available to common shareholders in basic EPS." However, the scope of this guidance does not include convertible debt with down-round features.
- ASU 2020-06 clarifies that the "average market price should be used to calculate the diluted EPS denominator" when the exercise price or the number of shares that may be issued is variable, except for certain contingently issuable shares.



Connecting the Dots

ASC 260 contains specific diluted EPS guidance that applies to contracts that may be settled in cash or stock. This guidance applies regardless of whether the option to elect the form of settlement is controlled by the entity or by the counterparty to the contract. Before the adoption of ASU 2020-06, if certain conditions were met, an entity could overcome the presumption of share settlement for contracts that may be settled in cash or stock. In such cases, the entity would not include the dilutive effect of such contracts in the denominator of diluted EPS. However, after the ASU's adoption, except for certain share-based payment arrangements, an entity must assume that in the calculation of diluted EPS, any contract that allows for settlement in shares will be settled in shares. As a result, the entity would include potential common shares in the denominator of diluted EPS by using the treasury stock method, reverse treasury stock method, if-converted method, or contingently issuable share method, as applicable. In some situations, the entity may also need to adjust the numerator in the calculation of diluted EPS.

Arrangements that commonly allow for settlement in cash or shares include convertible instruments and warrants on common stock. However, ASC 260-10-45-45 applies to all contracts that allow for settlement in cash or shares at the option of the entity or the counterparty. Therefore, other contracts, such as redeemable noncontrolling interests that may be settled in parent shares or lease agreements that permit rent to be paid in shares, are also subject to this guidance.

Even if share settlement is unlikely, the guidance in ASC 260-10-45-45 applies. That is, the intent of the party that may elect the form of settlement is not relevant in the application of this guidance. Therefore, to comply with ASC 260-10-45-45, entities will need to inventory all of their contracts that allow for settlement in shares.

For an in-depth discussion of the application of ASC 260, see Deloitte's Roadmap *Earnings per Share*.

10.3.5.5 Effective Date and Transition

The amendments in ASU 2020-06 are effective as follows:

- For PBEs that are not smaller reporting companies as defined by the SEC, fiscal years beginning after December 15, 2021, and interim periods within those fiscal years.
- For all other entities, fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.

The guidance may be early adopted for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. For convertible instruments that include a down-round feature, entities may early adopt the amendments that apply to down-round features if they have not yet adopted the amendments in ASU 2017-11.

For more information about ASU 2020-06, see Deloitte's August 5, 2020, *Heads Up*.

10.3.6 Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (ASU 2021-04)

In May 2021, the FASB issued ASU 2021-04, which addresses an issuer's accounting for certain modifications and exchanges of freestanding equity-classified written call options. Under the ASU, an entity accounts for a modification or exchange of a freestanding equity-classified written call option that remains equity classified after the modification or exchange by recognizing "the excess, if any, of the fair value of the modified or exchanged written call option over the fair value of that written call option immediately before it is modified or exchanged . . . on the basis of the substance of the transaction, in the same manner as if cash had been paid as consideration." Accordingly, an entity accounts for any incremental fair value provided to the counterparty in a modification or exchange of an equity-classified written call option.

The accounting applied depends on the reason for the modification or exchange (e.g., whether other transactions were entered into contemporaneously or in contemplation of the modification or exchange of the option, and whether any other rights or privileges were exchanged). An entity therefore accounts for the effect of the modification or exchange in the same manner as if cash had been paid as consideration. Such effect is measured as the difference between the option's fair value immediately before and immediately after the modification or exchange. The table below summarizes how to apply this guidance in different scenarios.

Transaction	Accounting for Incremental Fair Value	Guidance
Financing transaction to issue equity (ASC 815-40-35-17(a))	Treat the amount as equity issuance cost.	ASC 340-10-S99-1
Financing transaction to issue debt (ASC 815-40-35-17(b))	If the instrument is held by the creditor, treat the amount as a debt discount. If the instrument is held by a third party, treat the amount as a debt issuance cost.	ASC 835-30
Nontroubled debt modification or exchange (ASC 815-40-35-17(c))	If the instrument is held by the creditor, treat the amount as day 1 cash flow in the performance of the 10 percent test and as a fee paid to the creditor in the accounting for the modification or exchange. If the instrument is held by a third party, treat the amount as a third-party cost in the accounting for the modification or exchange.	ASC 470-50
Troubled debt restructuring (ASC 815-40-35-17(c))	If the instrument is held by the creditor, treat the amount as a fee paid to the creditor. If the instrument is held by a third party, treat the amount as a third-party cost.	ASC 470-60
Other	Treat the amount in accordance with other GAAP (e.g., ASC 606 or ASC 718). If the transaction is not within the scope of other GAAP, recognize as a dividend under ASC 260-10.	Other relevant topics or subtopics

ASC 815-40-35-17 (as added by ASU 2021-04) specifies that an entity should recognize as a dividend the effect of a modification or exchange that is not related to a financing transaction and is not within the scope of other GAAP (e.g., ASC 606 or ASC 718). An entity cannot assume that dividend recognition is appropriate for a transaction that is not specifically mentioned in ASC 815-40-35-17. Rather, it must carefully consider the related facts and circumstances and the substance of the transaction. Generally, the recognition of an expense is appropriate if the modification or exchange of the option represents compensation for other stated or unstated transaction elements (e.g., a standstill agreement or settlement of litigation). Paragraph BC19 of ASU 2021-04 states:

> Additionally, the [EITF] noted that if a modification or an exchange is executed in exchange for an agreement by the holder of the written call option to abandon certain acquisition plans, forgo other planned transactions, settle litigation, settle employment contracts, or voluntarily restrict its purchase of shares of the issuing entity or the issuing entity's affiliates within a stated time period, those rights and privileges obtained, both stated and unstated, or other elements of the transaction should be accounted for according to their substance (that is, as a cost to the issuing entity) rather than as a dividend distribution.

If the modification or exchange involves more than one of the categories identified above (i.e., it involves multiple elements), the amount is allocated among those categories.

10.3.6.1 Effective Date and Transition

ASU 2021-04 is effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years, with early adoption permitted. The ASU is applied on a prospective basis.

Appendix B — Titles of Standards and Other Literature

AICPA Literature

Accounting and Valuation Guides

Assets Acquired to Be Used in Research and Development Activities

Valuation of Privately-Held-Company Equity Securities Issued as Compensation

Clarified Statements on Auditing Standards

AU-C Section 501, "Audit Evidence — Specific Considerations for Selected Items"

AU-C Section 620, "Using the Work of an Auditor's Specialist"

FASB Literature

ASC Topics

ASC 105, *Generally Accepted Accounting Principles*

ASC 205, *Presentation of Financial Statements*

ASC 210, *Balance Sheet*

ASC 220, *Income Statement — Reporting Comprehensive Income*

ASC 230, *Statement of Cash Flows*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 260, *Earnings per Share*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 280, *Segment Reporting*

ASC 310, *Receivables*

ASC 320, *Investments — Debt Securities*

ASC 321, *Investments — Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 326, *Financial Instruments — Credit Losses*

ASC 330, *Inventory*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 410, *Asset Retirement and Environmental Obligations*

ASC 420, *Exit or Disposal Cost Obligations*

ASC 440, *Commitments*

ASC 450, *Contingencies*

ASC 460, *Guarantees*

ASC 470, *Debt*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 505, *Equity*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 705, *Cost of Sales and Services*

ASC 710, *Compensation — General*

ASC 712, *Compensation — Nonretirement Postemployment Benefits*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 730, *Research and Development*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 808, *Collaborative Arrangements*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 820, *Fair Value Measurement*

ASC 825, *Financial Instruments*

ASC 830, *Foreign Currency Matters*

ASC 832, *Government Assistance*

ASC 835, *Interest*

ASC 840, *Leases*

ASC 842, *Leases*

ASC 845, *Nonmonetary Transactions*

ASC 848, *Reference Rate Reform*

ASC 855, *Subsequent Events*

ASC 860, *Transfers and Servicing*

ASC 905, *Agriculture*

ASC 915, *Development Stage Entities*

ASC 930, *Extractive Activities — Mining*

ASC 944, *Financial Services — Insurance*

ASC 946, *Financial Services — Investment Companies*

ASC 948, *Financial Services — Mortgage Banking*

ASC 954, *Health Care Entities*

ASC 958, *Not-for-Profit Entities*

ASC 960, *Plan Accounting — Defined Benefit Pension Plans*

ASC 970, *Real Estate — General*

ASC 985, *Software*

ASUs

ASU 2010-27, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers* — a consensus of the FASB Emerging Issues Task Force

ASU 2011-06, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

ASU 2014-10, *Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810,* Consolidation

ASU 2014-15, *Presentation of Financial Statements — Going Concern (Subtopic 205-40): Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern*

ASU 2014-16, *Derivatives and Hedging (Topic 815): 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* — a consensus of the FASB Emerging Issues Task Force

ASU 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments*

ASU 2016-01, *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

ASU 2016-02, *Leases (Topic 842)*

ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*

ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* — a consensus of the FASB Emerging Issues Task Force

ASU 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*

ASU 2016-17, *Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control*

ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash* — a consensus of the FASB Emerging Issues Task Force

ASU 2016-20, *Technical Corrections and Improvements to Topic 606,* Revenue From Contracts With Customers

ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*

ASU 2017-04, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*

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, (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*

ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

ASU 2018-07, *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*

ASU 2018-08, *Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*

ASU 2018-10, *Codification Improvements to Topic 842,* Leases

ASU 2018-11, *Leases (Topic 842): Targeted Improvements*

ASU 2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*

ASU 2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction Between Topic 808 and Topic 606*

ASU 2019-01, *Leases (Topic 842): Codification Improvements*

ASU 2019-04, *Codification Improvements to Topic 326,* Financial Instruments — Credit Losses*, Topic 815,* Derivatives and Hedging*, and Topic 825,* Financial Instruments

ASU 2019-05, *Financial Instruments — Credit Losses (Topic 326): Targeted Transition Relief*

ASU 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

ASU 2019-11, *Codification Improvements to Topic 326,* Financial Instruments — Credit Losses

ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*

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Appendix C — Abbreviations

Abbreviation	Description
AETR	annual effective tax rate
AFS	available for sale
AFSI	adjusted financial statement income
AI	artificial intelligence
AICPA	American Institute of Certified Public Accountants
AIN	AICPA Accounting Interpretation of an APB Opinion
AMT	alternative minimum tax
ANDA	abbreviated new drug application
APB	Accounting Principles Board
API	active pharmaceutical ingredient
ARO	asset retirement obligation
ASC	FASB Accounting Standards Codification
ASR	accelerated share repurchase
ASU	FASB Accounting Standards Update
AUD	Australian dollar
BCF	beneficial conversion feature
BEAT	base erosion anti-abuse tax
BEMTA	base erosion minimum tax amount
BPD	branded prescription drug
C&DIs	Compliance and Disclosure Interpretations
CAM	critical audit matter
CAQ	Center for Audit Quality
CARES Act	Coronavirus Aid, Relief, and Economic Security Act
CCF	cash conversion feature

Abbreviation	Description
CECL	current expected credit loss
CFC	controlled foreign corporation
CIMA	Chartered Institute of Management Accountants
CMO	contract manufacturing organization
CRO	contract research organization
CSRD	Corporate Sustainability Reporting Directive
DTA	deferred tax asset
DTL	deferred tax liability
EBITDA	earnings before interest, taxes, depreciation, and amortization
ED	exposure draft
EDGAR	SEC electronic data gathering, analysis, and retrieval system
EGC	emerging growth company
EITF	Emerging Issues Task Force
ELOC	equity line of credit
EPS	earnings per share
ESA	energy service agreement
ESG	environmental, social, and governance
ESPP	employee stock purchase plan
ESRS	European Sustainability Reporting Standards
EUR	euros
Exchange Act	Securities Exchange Act of 1934
FASB	Financial Accounting Standards Board
FAST Act	Fixing America's Surface Transportation Act

Abbreviation	Description
FDA	U.S. Food and Drug Administration
FDII	foreign-derived intangible income
FOB	free on board
FPI	foreign private issuer
FRM	SEC Division of Corporation Finance Financial Reporting Manual
FVO	fair value option
FVTOCI	fair value through other comprehensive income
GAAP	generally accepted accounting principles
GenAI	generative artificial intelligence
GHG	greenhouse gas
GILTI	global intangible low-taxed income
GloBE	Global anti-Base Erosion
GPO	group purchasing organization
HAFWP	how and for what purpose
HFI	held for investment
HFS	held for sale
HVAC	heating, ventilation, and air conditioning
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IBNR	incurred but not reported
ICFR	internal control over financial reporting
IFRIC	IFRS Interpretations Committee
IFRS	International Financial Reporting Standard
IIR	investigator-initiated research
IP	intellectual property
IPO	initial public offering
IPR&D	in-process research and development
IRC	Internal Revenue Code
IRS	Internal Revenue Service
ISO	incentive stock option

Abbreviation	Description
ISSB	International Sustainability Standards Board
IT	information technology
ITC	invitation to comment
JOBS Act	Jumpstart Our Business Startups Act
LCD	liquid-crystal display
LIBOR	London Interbank Offered Rate
LIFO	last in, first out
M&A	merger and acquisition
MD&A	Management's Discussion & Analysis
MNE	multinational enterprise
MSL	medical science liaison
NDA	new drug application
NFP	not-for-profit (entity)
NIH	National Institutes of Health
NOL	net operating loss
NOPA	notice of proposed adjustment
NQSO or **NSO**	nonqualified stock option
OCA	SEC's Office of the Chief Accountant
OCI	other comprehensive income
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacturer
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PIPE	private investment in public equity
PP&E	property, plant, and equipment
PRV	priority review voucher
PTRS	probability of technical and regulatory success
Q&A	question and answer
QIP	qualified improvement property

Abbreviation	Description
R&D	research and development
R&E	research and experimental
REC	renewable energy certificate
REMS	risk evaluation and mitigation strategy
RIM	retail inventory method
ROU	right of use
SaaS	software as a service
SAB	Staff Accounting Bulletin
SEC	U.S. Securities and Exchange Commission
Securities Act	Securities Act of 1933
SEPA	standby equity purchase agreement
SOX	Sarbanes-Oxley Act of 2002
SPAC	special-purpose acquisition company
SPPI	solely payments of principal and interest
SRC	smaller reporting entity
S&P 500	Standard & Poor's 500 Index
TD	Treasury Decision
TDR	troubled debt restructuring
TRG	transition resource group
TRWG	IFRS Foundation Technical Readiness Working Group
TSA	transition services agreement
USD	U.S. dollars
UTB	unrecognized tax benefit
VIE	variable interest entity
VWAP	volume-weighted average daily market price
XBRL	eXtensible Business Reporting Language

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