Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** ASU 2020-06 - Convertible Instruments

**Check (applicable entity):**

 P/C Life Health

Modification of Existing SSAP [x]  [x]  [x]

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

Description of Issue: *ASU 2020-06, Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40), Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity* intends to address issues identified as a result of the complexity associated with applying U.S. generally accepted accounting principles (U.S. GAAP) for certain financial instruments with characteristics of liabilities and equity. Complexity associated with the accounting is a significant contributing factor to numerous U.S. GAAP financial statement restatements and has resulted in complexity for users attempting to understand the results of applying the current guidance.

Under current U.S. GAAP, there are five accounting models for convertible debt instruments. Except for the traditional convertible debt model that recognizes a convertible debt instrument as a single debt instrument, the other four models, with their different measurement guidance, require that a convertible debt instrument be separated (using different separation approaches) into a debt component and an equity or a derivative component. Convertible preferred stock also is required to be assessed under similar models. The amendments in ASU 2020-06 provide financial statement users with a simpler and more consistent starting point to perform analyses across entities. The amendments also improve the operability of the guidance and reduce, to a large extent, the complexities in the accounting for convertible instruments and the difficulties with the interpretation and application of the relevant guidance.

The amendments to the derivatives scope exception for contracts in an entity’s own equity change the population of contracts that are recognized as assets or liabilities. For a freestanding instrument, if the instrument qualifies for the derivatives scope exception under the amendment, an entity should record the instrument as equity. For an embedded feature, if the feature qualifies for the derivatives scope exception under the amendment, an entity should no longer bifurcate the feature and account for it separately.

ASU 2020-06 also provides updated guidance on earnings per share calculations.

Existing Authoritative Literature:

1. Earnings per share – Rejected as Not Applicable for Statutory Accounting:

The concept of earnings per share (Topic 260) has previously been reviewed with the following U.S. GAAP standards rejected as not applicable in *Appendix D—Nonapplicable GAAP Pronouncements:*

* *FASB Statement No. 128, Earnings per Share* (FAS 128)
* *EITF 07-04, Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships*
1. Distinguishing Liabilities from Equity / Derivatives and Hedging:

*SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* defines a liability with excerpts below:

Financial Instruments with Characteristics of both Liabilities and Equity

1. Issued, free-standing financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent the instruments embodies an unconditional obligation of the issuer. (Pursuant to SSAP No. 86, embedded features in derivative contracts shall not be separated from the host contract for separate recognition.) Free-standing financial instruments that meet any of the criteria below meet the definition of a liability:
2. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the issuing reporting entity.
3. A financial instrument, other than an outstanding share, that at inception 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.
4. Obligations that permit the holder to require the issuer to transfer assets.
5. A financial instrument is a liability if the issuer must settle the obligation by issuing a variable number of its equity shares and the obligation’s monetary value is based solely or predominantly on: 1) a fixed monetary amount, 2) variation 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.
6. Instruments in which the counterparty (holder) is not exposed to the risks and benefits that are similar to those of a holder of an outstanding share of the entity’s equity shall be classified as a liability.
7. If a free-standing financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument. However, that financial instrument shall be assessed each reporting period to determine whether circumstances have changed such that the instrument meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument shall be reclassified as a liability.
8. The classification of a free-standing financial instrument as a liability or equity shall only apply to the instrument issuer. Holders or purchasers of such instruments shall refer to the appropriate investment statement for valuation and reporting.

### *SSAP No. 72—Surplus and Quasi-Reorganizations*

### Capital Stock

The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share. The capital stock account represents the number of shares issued times the par value of each share. When no par value is set forth, the reporting entity shall declare a “stated value” and record such amount in the capital stock account. Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Issued, free-standing financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent described in SSAP No. 5R.

*SSAP No. 104R—Share-Based Payments, Exhibit A – Classification Criteria: Liability or Equity*

Mandatorily Redeemable Financial Instruments

1. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.
2. A [financial instrument](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2268724-110875) that embodies a conditional obligation to redeem the instrument by [transferring](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2272196-110875) assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.
3. In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:
	1. A term extension option
	2. A provision that defers redemption until a specified liquidity level is reached
	3. A similar provision that may delay or accelerate the timing of a mandatory redemption.
4. If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this statement. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

Obligations to Repurchase Issuer’s Equity Shares by Transferring Assets

1. An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:
	1. It embodies an [obligation](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2272201-110875) to repurchase the [issuer’s equity shares](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2272207-110875), or is indexed to such an obligation, and
	2. It requires or may require the [issuer](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2272211-110875) to settle the obligation by transferring assets.
2. In this statement, “indexed to” is used interchangeably with “based on variations in the [fair value](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2268666-110875) of.” The phrase “requires or may require” encompasses instruments that either conditionally or unconditionally obligate the issuer to [transfer](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2267936-110875) assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.
3. Examples of financial instruments that meet the criteria in paragraph 7 of this Exhibit include forward purchase contracts or written put options on the issuer’s equity shares that are to be physically settled or net cash settled.
4. All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): The Working Group addressed similar issue in agenda item 2019-43, and adopted language that was included in the “Existing Authoritative Literature” section, primarily in SSAP No. 5R.

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:**

None

**Convergence with International Financial Reporting Standards (IFRS):** N/A

Staff Recommendation:

NAIC staff recommends the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 5R, SSAP No. 72 and SSAP No. 86 to reject *ASU 2020-06, Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40), Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity* for statutory accounting as this update primarily addresses various convertible debt valuation models (a concept not employed by statutory accounting) as well as require bifurcating embedded derivative components (a concept not permitted under statutory accounting).

**Staff Review Completed by:**

Jake Stultz, NAIC Staff – September 2020

**Status:**

On November 12, 2020, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*, *SSAP No. 72—Surplus and Quasi-Reorganizations* and *SSAP No. 86—Derivatives*, to reject *ASU 2020-06, Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40), Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity* for statutory accounting, as illustrated below.

SSAP No. 5R

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

SSAP No. 72

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

SSAP No. 86

1. This statement rejects *ASU 2020-06, Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40), Accounting for Convertible Instruments and Contracts in an Entity’s Own* Equity, *ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities*, and *ASU 2016-03, Intangibles—Goodwill and Other, Business Combinations, Consolidation, Derivatives and Hedging*.

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