MEMO	Memo No.	**2**	
	Issue Date	**September 11, 2025**	
	Meeting Date	**PCC Meeting September 26, 2025**	

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Project	**PCC Agenda Priorities**
Project Stage	**Private Company Pre-Agenda Research**
Issue	**Interest Method and Determining the Effective Interest Rate**

Background Information and Memo Purpose

1. During the June 27, 2025, Private Company Council (PCC) meeting, PCC members discussed the staff's research (including outreach) on the challenges of applying the interest method guidance in Topic 835, Interest, and potential private company alternatives. The PCC indicated that this issue should continue to be pursued as a current agenda priority and should be discussed at a future PCC meeting. The PCC also requested additional research on how a potential private company alternative would apply (a) if the borrower allocates proceeds received between the debt instrument and another instrument or embedded feature or (b) to debt instruments that are initially measured at fair value. Some PCC members also discussed the interaction with the guidance in Subtopic 470-50, Debt—Modifications and Extinguishments.

2. The purpose of this memo is to (a) provide an update on the staff's research (including outreach) conducted since the June 27, 2025 PCC meeting and (b) request feedback from PCC members on the issues covered in this memo. The PCC is not expected to make any decisions during this meeting.

Questions for the PCC
Scope (see paragraphs 33 through 93): 1. In your experience do the following areas result in the recognition of significant debt discounts or premiums? a. **Allocation of proceeds to multiple units of account** (for example, due to issuance with detachable warrants or separate recognition of an embedded derivative) b. **Initial measurement at fair value** (for example, due to business combination or extinguishment accounting) c. **Reset of the effective interest rate** (for example, following the application of modification accounting or the requirements for troubled debt restructurings (TDRs))

Questions for the PCC

2. Pending additional staff research, does the PCC have a preliminary preference for one of the following scope exceptions to the potential private company alternative?
    a. **No scope exceptions:** An entity could apply the potential private company alternative to all issued debt instruments that are currently subject to the interest method
    b. **Specific scope exceptions:**
        1. Debt instruments initially measured at fair value
        2. Debt instruments for which proceeds are allocated among multiple units of account
        3. Debt instruments for which the effective interest rate is reset (due to the guidance on debt modifications and TDRs)
    c. **Broad scope exception 1 (“Substantial Premium or Discount”):** A scope exception for debt instruments that “involve a substantial premium or discount” (based on existing guidance in paragraph 815-15-25-42) (see paragraph 66)
    d. **Broad scope exception 2 (10 Percent Bright-Line):** A scope exception for debt instruments for which any amounts to be amortized on a straight-line basis (including a discount or premium) exceeds 10 percent of the undiscounted cash flows.
3. Pending additional staff research, does the PCC have a preliminary preference for whether instruments initially accounted for as a single unit of account but are subsequently bifurcated should be permitted to apply the potential private company alternative?

Interaction with the Guidance in Subtopic 470-50 (Modifications and Extinguishments) and Subtopic 470-60, Debt—Troubled Debt Restructurings by Debtors (see paragraphs 94 through 112):

4. In your experience, when entities have applied the straight-line method (due to immateriality), how have private companies applied the guidance on (a) the 10 percent test in Subtopic 470-50 and (b) determining whether a concession has been granted in Subtopic 470-60? For example, have private companies:
    a. Used the effective interest rate disclosed in accordance with Topic 835
    b. Calculated the effective interest rate based on the loan’s carrying amount at inception
    c. Calculated a new effective interest rate based on the loan’s current carrying amount
    d. Not usually applicable (for example, because of prepayment provisions).
5. Pending additional staff research, does the PCC have a preliminary preference for whether the 10 percent test in Subtopic 470-50 and the method for determining whether a concession has been granted in Subtopic 470-60 should be revised for entities that apply the potential private company alternative? If so, which of the following methods should be required?
    a. Determining the effective interest rate using the debt’s carrying amount immediately before the modification or exchange
    b. For debt modifications and exchanges, discounting the cash flows for the new and modified debt using the contractual interest rate. For TDRs, allow the original debt’s contractual rate to be used in place of the original debt’s effective rate (no change to the calculation for the effective rate of the restructured debt).
    c. Other (and please explain).

Questions for the PCC
Special Debt Accounting Models and Income Taxes (see paragraphs 113 through 128):
6. Does the PCC have any questions or feedback on the staff's research on Special Debt Accounting Models (for example, variable rate loans and sales of future revenues) or Income Taxes?
Next Steps (see paragraph 129):
7. Does the PCC have questions or comments on next steps?

3. This memo is organized as follows:

(a) Summary of the Potential Private Company Alternative

(b) Overview of Outreach Conducted and Overall Sentiment

(c) Private Company Decision-Making Framework and Past User Outreach on Debt Modifications

(d) Scope of a Potential Private Company Alternative

(e) Interaction with the Guidance on Modifications, Extinguishments, and TDRs

(f) Staff Research: Special Debt Accounting Models

(g) Consideration of Agenda Consultation Feedback

(h) Income Taxes

(i) Next Steps

(j) Appendix A: Summary of Other Research on Specialized Areas of Debt Accounting

(k) Appendix B: Income Tax Accounting for Debt Issued with Warrants, Bifurcated Derivatives, and Debt Modifications.

Summary of the Potential Private Company Alternative

4. During its June meeting, the PCC discussed two possible alternatives to the interest method. The PCC did not express support for further consideration of an option allowing only debt issuance costs—excluding other amounts related to a debt discount or premium—to be amortized using the straight-line method. However, both PCC and Board members indicated that the staff should continue researching a potential private company alternative to the interest method, in which an entity would determine periodic interest expense as described below:

(a) Amounts designated in the loan agreement as interest

(b) +/ − Amortization of debt discount or premium on a straight-line basis (including any debt discount or premium arising from bifurcation at issuance)

(c) +/ − Amortization of debt issuance costs on a straight-line basis.

5. Although the PCC was not asked to make decisions on potential alternatives during the June meeting, feedback from PCC members and staff outreach conducted before the meeting indicated that this approach is consistent with how many private companies amortize debt instruments in practice, provided that the results do not materially differ from those obtained under the interest method.

6. Therefore, for the purposes of this memo, the staff's research relates specifically to this potential alternative.

Overview of Outreach Conducted and Overall Sentiment

Overview of Outreach Conducted

7. Following the June PCC meeting, the staff conducted outreach with practitioners to better understand their experience and perspectives on: (a) debt instruments issued at a significant discount or premium, (b) private companies' application of the straight-line method, and (c) the interaction between the straight-line method and guidance on debt modifications, (d) special debt accounting models, and (e) accounting for income taxes. The outreach included discussions with representatives from four mid-size accounting firms and two Big Four firms.

Overall Sentiment Shared in Outreach

8. Although the staff's feedback was designed primarily to solicit feedback on the potential private company alternative's scope and its potential interaction with the guidance on debt modifications and extinguishments, three practitioners volunteered that they did not support establishing a private company alternative to the interest method. Other practitioners indicated that establishing an alternative to the interest method is not a high priority. One practitioner highlighted that their mid-market private company clients struggle with applying the interest method in practice and noted that the potential private company alternative could be helpful.

9. Four practitioners indicated that applying the interest method to most debt instruments does not pose a significant challenge in practice and, instead, that there are more pressing challenges in applying the guidance in Topic 470, Debt. Some noted, for example, that there is a lack of specific guidance for certain common instruments (such as certain debt instruments with variable cash flows). While one of those practitioners acknowledged that some entities may be applying the straight-line method in practice, they also indicated that they are generally able to assess materiality with little difficulty. Two practitioners emphasized that basic functions in spreadsheet software and publicly available online tools explain how to calculate an effective interest rate and apply the interest method. One practitioner stated that establishing a private company alternative in this particular area could create challenges for entities that later become public business entities.

10. Several practitioners noted that further consideration should be given to whether any issues related to the interest method would be better addressed through educational materials rather than through a private company alternative. One of those practitioners also suggested establishing a framework to better differentiate issues that represent educational issues from those that require standard setting.

11. By contrast, one practitioner expressed measured support for a potential project in this area. For example, that practitioner noted that their client base—which consists largely of private equity portfolio companies—might benefit from an alternative to the interest method. However, while expressing support for a possible private company alternative, that practitioner also indicated that this topic is not a high priority.

12. A different practitioner expressed support for a potential project in this area and indicated that a potential private company alternative could reduce the challenges currently encountered by auditors when assessing whether an entity's use of a method other than the interest method is appropriate.

Private Company Decision-Making Framework and Past User Outreach on Debt Modifications

Background

13. During the June PCC meeting, a Board member highlighted the importance of considering the guidance in the Private Company Decision-Making Framework (PCDMF) when considering a potential recognition or measurement alternative.

14. Therefore, to assist PCC members in providing initial feedback at this meeting on the potential private company alternative, this section includes a high-level summary of the discussion in the PCDMF on recognition and measurement alternatives. After conducting outreach with users, the staff plans to present an analysis of the PCDMF before seeking decisions from PCC members.

Determining Recognition and Measurement Guidance

15. When considering potential recognition and measurement differences, the PCDMF states that the Board and the PCC first should determine whether the recognition or measurement guidance being evaluated provides relevant information to users of private company financial statements at a reasonable cost. That analysis should focus on (a) the relevance of the information in meeting the objective of financial reporting for typical users of private company financial statements, (b) the characteristics that differentiate users of private company financial statements from users of public company financial statements, and (c) the cost and complexity of applying the guidance.

16. The PCDMF further notes that, if the Board and the PCC determine that either (a) the information provided by the guidance is not relevant or (b) the information provided by the guidance is relevant but is overly costly or complex to provide and no practical expedient is available, they should proceed to

analyzing the benefits and costs of potential alternative recognition or measurement methods for private companies.

Assessing Relevance

17. The PCDMF outlines questions to assess the relevance of information for users of private company financial statements, including:

    (a) Does the transaction, event, or balance affect reported cash, cash flows, or adjusted EBITDA?

    (b) Does the transaction, event, or balance significantly affect borrowings, liquidity, or leverage?

    (c) Does the transaction or event affect, or does the balance relate to, trade receivables, inventories, fixed assets, other long-term tangible assets, accounts payable, or other liabilities?

    (d) Do users typically consider the quantitative effect of the transaction, event, or balance when evaluating collateral, financial performance, or financial position? Consider whether users typically adjust financial statements by substituting an alternative accounting approach.

    (e) Does the guidance require recognizing and measuring transactions for which uncertainty exists on the basis of the expected most likely outcome?

    (f) Does the guidance relate to loss contingencies or commitments that could significantly affect future cash flows?

    (g) Does the measurement guidance reflect volatility in financial statements resulting from underlying changes in market prices of debt instruments or certain derivatives that are expected to reverse contractually in the future because the entity has the intent and ability to hold the instrument or derivative to its defined maturity or term?

Assessing Cost and Complexity

18. The PCDMF also outlines the following questions that pertain to cost and complexity:

    (h) Does application of the guidance often require assistance from outside resources at a significant cost?

    (i) Is significant complexity involved in determining or evaluating the initial and/or ongoing accounting treatment?

    (j) Are there expected to be significant changes to information systems, contracts, internal controls, or processes as a result of applying the new guidance?

    (k) Is the accounting treatment costly to audit, review, or compile?

Further Considerations

19. The PCDMF states that the Board and the PCC should place more weight on the overall responses to questions relating to relevance to users (questions (a)–(g)). They generally should place a lesser, but significant, weight on the overall responses to questions relating to cost and complexity (questions (h)–(k)). It also notes that the Board and the PCC should not provide alternatives (beyond practical expedients) for private companies when recognizing or measuring the type of information on which typical users of private company financial statements commonly focus. It states that no alternatives within U.S. GAAP should be considered unless input from users indicates that a difference or change is appropriate.

Access to Management

20. The PCDMF states that access to management should not primarily influence recognition and measurement in GAAP financial statements because these reports are intended for all users.

> DF5. In terms of recognition and measurement implications, access to management cannot be a primary differentiating factor because U.S. GAAP financial statements are general purpose and must serve the needs of all users to whom they are provided. Failure to recognize or measure relevant financial information would hinder users' ability to understand the economics of the company, thereby hindering the ability to identify the questions to ask management. Financial statements must contain a consistent base amount of information that permits all users to obtain an understanding of the key economic activities and changes in those activities. That generally means that access to management should have no implications on whether there should be recognition and measurement alternatives for private companies within U.S. GAAP. That supports the concept that recognition and measurement differences for private companies within U.S. GAAP should be driven primarily by relevance and secondarily by cost and complexity considerations. However, once it has been decided that a recognition and measurement alternative should be provided, access to management can be considered in evaluating potential alternatives for private companies within U.S. GAAP.

21. The PCDMF also notes that access to management should be viewed as a mitigating factor in evaluating cost-benefit considerations, including the risk that some users might find public company recognition or measurement guidance to be more relevant. The PCDMF explains that, if the Board and the PCC limit alternatives for private companies to those areas of U.S. GAAP that do not have broad or significant relevance to typical users of private company financial statements, relatively few users are expected to need access to management to obtain additional information relating to transactions or events for which an alternative method has been applied.

Past User Outreach on Debt Modifications

22. In materials prepared for the September 24, 2024 PCC meeting, the staff summarized outreach conducted with users (specifically, lenders) on questions related to the relevance of modification accounting and extinguishment accounting under Subtopic 470-50. Although that feedback was focused on the guidance in Subtopic 470-50 and an alternative to the interest method was not

discussed, the staff notes that several areas of feedback could also be relevant to a potential private company alternative.

23. Overall, users indicated that capital allocation decisions are based on the borrower's (or prospective borrower's) ability to pay its debt obligations through its cash flows and that the financial reporting outcomes (specifically, modification and extinguishment accounting under Subtopic 470-50) generally do not affect those decisions.

24. On the calculation of interest expense, users stated that they focus on *cash interest paid* instead of *interest expense* computed under the interest method. Therefore, users explained that the effect of applying the modifications and extinguishments guidance in Subtopic 470-50 on interest expense does not affect capital allocation decisions. One user specifically noted that they look to the supplemental disclosure of cash paid for interest in the statement of cash flows to understand the borrower's ability to service its debt through future cash flows. That user also stated that the effect of modification accounting or extinguishment accounting on interest expense is viewed as a timing difference and that they were not concerned about that potential timing difference.

Staff Observations: How the Calculation of Interest Expense Can Affect Cash Interest Paid Disclosure

25. In past outreach, users distinguished between *cash interest paid* and *interest expense*. However, the staff notes that the calculation of those two metrics can be related; in certain cases, the determination of cash interest paid may be affected by the calculation of interest expense using the interest method.

26. Topic 230, Statement of Cash Flows (paragraph 230-10-50-2), requires that an entity disclose the amounts of interest paid (net of amounts capitalized). For many debt arrangements, particularly term loans issued at par or at a small discount, the coupon payment may equal the amount of cash interest paid in the period and, therefore, the entire payment will be classified as interest (a cash outflow from operations).[1]

27. For other debt arrangements, such as amortizing loans and instruments with coupon interest rates that are insignificant when compared to the effective interest rate, entities may be required to allocate cash payments between interest (classified as an operating outflow) and principal (classified as a financing outflow).

28. Paragraph 230-10-45-22 provides the following overall guidance on cash receipts and payments that may have aspects of more than one class of cash flows.

> **230-10-45-22** Certain cash receipts and payments may have aspects of more than one class of cash flows. *The classification of those cash receipts and payments shall be determined first by applying specific guidance in this Topic and other applicable Topics*.

[1] Under the indirect method, this would be reflected in operating activities by adjusting the amount of discount amortization when reconciling net income to cash flow from operations.

In the absence of specific guidance, a reporting entity shall determine each separately identifiable source or each separately identifiable use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows, including when judgment is necessary to estimate the amount of each separately identifiable source or use. A reporting entity shall then classify each separately identifiable source or use within the cash receipts and payments on the basis of their nature in financing, investing, or operating activities. [Emphasis added.]

29. An example of a cash payment involving more than one class of cash flow would be the periodic repayment of an amortizing loan, which comprises a combination of interest payments and principal repayments. While Topic 230 does not specifically discuss amortizing loans, nonauthoritative guidance from a practitioner publication highlights that, in practice, the allocation of the repayments between interest and principal may sometimes be in accordance with the interest method in Topic 835.[2]

6.8.1 Cash flows with aspects of more than one class

Judgment may be necessary to determine how and when cash flows should be bifurcated, as well as to estimate the amount of each separately identifiable source or use. In making these determinations, a reporting entity should look to the application of other US GAAP. *For example, when a reporting entity makes a quarterly payment on amortizing debt, it uses ASC 835, Interest, to determine the portion of the payment that relates to interest expense (which enters into the determination of net income) and the portion related to principal. For purposes of the statement of cash flows, the different natures of these separately identifiable uses cause the interest expense portion to be classified as operating and the principal portion to be classified as financing. We generally believe the application of other US GAAP will be indicative of when and how cash flows should be bifurcated.* [Emphasis added.]

30. Similarly, repayments of zero-coupon debt instruments are required to be allocated between interest and principal.

230-10-45-15 All of the following are cash outflows for financing activities:

b. Repayments of amounts borrowed, including the portion of the repayments made to settle zero-coupon debt instruments that is attributable to the principal or the portion of the repayments made to settle other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing that is attributable to the principal.

230-10-45-17 All of the following are cash outflows for operating activities:

d. Cash payments to lenders and other creditors for interest, *including the portion of the payments made to settle zero-coupon debt instruments that is attributable to accreted interest related to the debt discount or the portion of the payments made to settle other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing that is attributable to accreted interest related to the debt discount*. For all other debt instruments, an issuer shall not bifurcate cash payments to lenders and other creditors at settlement for amounts attributable to accreted interest related to the debt discount, nor classify such amounts as cash outflows for operating activities.

[Emphasis added.]

[2] See PwC publication, *Financial Statement Presentation* (May 2025).

31. The purpose of highlighting this guidance is to illustrate that *cash interest paid* and *interest expense* could sometimes be related metrics and that changes to the requirements for calculating interest expense could affect the amounts disclosed as cash paid for interest for some entities.

32. Moreover, the staff observes that, given the potential effect on cash interest paid, it is important consider several questions in the PCDMF related to the relevance of information for users of private company financial statements. Specifically, for certain loans, an alternative to the interest method would affect (a) cash interest paid, (b) cash flows from operating activities, and (c) loan carrying amounts. Therefore, the staff thinks that amortizing a debt instrument under the potential private company alternative could affect both "reported…cash flows" and "borrowings, liquidity, or leverage" as discussed in the PCDMF (see paragraph 17(a) and (b) of this memo).

Scope of a Potential Private Company Alternative[3]

Background

33. In materials provided for the June 27, 2025 PCC meeting, the staff noted that the extent to which financial reporting outcomes would differ under the potential private company alternative and the interest method would depend on the relationship between the loan's contractual interest rate and its effective interest rate.[4] Those materials provided examples illustrating that when there is a significant disparity between the contractual and effective interest rates, periodic interest expense calculated under the interest method and the potential private company alternative could differ considerably.

34. During the June 27, 2025 PCC meeting, the Board and PCC discussed the scope of a potential private company alternative. Specifically, the Board and PCC discussed significant discounts that can arise when debt is issued with detachable warrants as well as discounts and premiums that arise when a private company applies the initial measurement requirements in Topic 805, Business Combinations. A PCC member noted that these scenarios might be addressed by adding disclosure requirements or by a scope exception that restricts the potential private company alternative to "simpler" debt instruments and referenced the guidance on "plain-vanilla swaps" in Topic 815, Derivatives and Hedging.[5] A PCC member also observed that simpler debt instruments may be more common than other types of debt instruments.

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[3] This section focuses exclusively on debt instruments subsequently measured at amortized cost and does not address instruments measured using the fair value option.

[4] The staff also notes that the loan term could affect the extent of differences in a particular period under the potential private company alternative and the interest method.

[5] See the amendments in Accounting Standards Update No. 2014-03, *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (a consensus of the Private Company Council)*.

35. To assist the PCC's consideration of the scope of a potential private company alternative, the staff has (a) conducted outreach with practitioners to obtain additional details about the instruments encountered in practice and practitioners' views on a potential scope, (b) provided additional background information on areas of existing GAAP that can result in differences between the effective interest rate and the contractual interest rate, and (c) provided new illustrations in this memo to highlight the effect the potential private company alternative could have on an entity's financial statements.

36. The remainder of this section is organized as follows:

    (a) Staff Research: Debt Discounts Resulting from Allocation of Proceeds to Multiple Units of Account

    (b) Staff Research: Multiple Units of Account After Issuance

    (c) Staff Research: Debt Discounts and Premiums Resulting from Initial Measurement at Fair Value

    (d) Staff Research: "Plain-Vanilla" and "Substantial Premiums and Discounts" in Topic 815

    (e) Outreach: Practitioner Perspectives on Scope

    (f) Staff Analysis.

Staff Research: Debt Discounts Resulting from Allocation of Proceeds to Multiple Units of Account

37. The allocation of proceeds among multiple units of account can cause a debt instrument to be initially measured at an amount different from the net proceeds received at issuance. This can occur when debt is issued together with other financial instruments (for example, detachable warrants) or contains an embedded derivative that is required to be bifurcated under Topic 815, Derivatives and Hedging.[6] [7]

Debt Issued with Other Financial Instruments

38. Debt may be issued together with other freestanding financial instruments, such as detachable warrants. Subtopic 470-20, Debt—Debt with Conversion and Other Options, establishes the following requirements for allocating proceeds when a debt instrument is issued together with warrants.

> **470-20-25-2** Proceeds from the sale of a debt instrument with stock purchase warrants (detachable call options) shall be allocated to the two elements based on the relative fair values of the debt instrument without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants shall be accounted for as paid-in capital. The remainder of the proceeds shall be allocated to the debt instrument portion of the transaction. This usually results in a discount (or, occasionally, a reduced premium), which shall be accounted for under Topic 835.

[6] There is also certain specialized guidance in Topic 470, such as the guidance on participating mortgages (when the lender is entitled to participate in the asset's market value appreciation), for certain debt instruments that may require an entity to allocate proceeds to multiple units of account. Appendix A also provides a summary of research on participating mortgages.

[7] Another specialized area in Topic 470 would include convertible debt issued at a substantial premium. However, the staff does not expect that application of this guidance would often lead to significant differences between the contractual interest rate and the effective interest rate.

39. In addition to the relative fair value method described in paragraph 470-20-25-2, other allocation approaches may be used in practice depending on the characteristics of the instruments issued with a debt instrument and the subsequent measurement requirements for those other instruments. For example, if liability-classified warrants are measured at fair value and issued together with a debt instrument, the staff understands that one approach applied in practice is to measure the warrants at fair value while measuring the debt instrument, which is subsequently measured at amortized cost, as the residual amount.

Debt With an Embedded Feature That Requires Bifurcation

40. When a debt instrument includes an embedded feature that must be separated and accounted for as a derivative, Topic 815 requires the use of an allocation method that initially measures the embedded derivative at fair value. According to this guidance, the host contract's initial carrying value is calculated as the residual amount, which is the difference between the hybrid instrument's basis and the embedded derivative's fair value.

Example: Allocation of Proceeds Impact on Effective Interest Rate

41. A private company issues a $1,000,000, 10-year amortizing loan with a contractual interest rate of 6 percent together with 100,000 equity-classified detachable warrants to purchase its common stock for total net proceeds of $1,000,000. Assume that the fair value of the debt is $735,000 and the fair value of the warrants is $315,000. Because of the requirement to provide separate recognition to the warrants on a relative fair value basis, the initial carrying amount of the debt instrument is $700,000 (the other $300,000 of proceeds is allocated to the warrants).[8]

42. Although the contractual interest rate is 6 percent, the effective interest rate (the interest rate that would result in $700,000 equaling the present value of the repayments) is 14.32 percent. Therefore, in this fact pattern, there would be a significant difference between the contractual interest rate and the effective interest rate and thus there would be a significant difference between the interest method and the potential private company alternative.

Interest Method

Date	Payment	Interest Expense	Principal Reduction	Carrying Amount
1/1/20X1	-	-	-	700,000
12/31/20X1	135,868	100,225	35,643	664,357
12/31/20X2	135,868	95,121	40,747	623,610
12/31/20X3	135,868	89,287	46,581	577,029
12/31/20X4	135,868	82,618	53,250	523,779
12/31/20X5	135,868	74,994	60,874	462,905
12/31/20X6	135,868	66,278	69,590	393,315
12/31/20X7	135,868	56,314	79,554	313,761

[8] [$735,000 ÷ ($735,000 + 315,000)] × $1,000,000 = $700,000.

Date	Payment	Interest Expense	Principal Reduction	Carrying Amount
12/31/20X8	135,868	44,924	90,944	222,817
12/31/20X9	135,868	31,902	103,966	118,851
12/31/20X0	135,868	17,017	118,851	-

Amortization (Potential Private Company Alternative)

Date	Payment	(A) Contractual Interest	(B) Amortization	(A) + (B) = Interest Expense	Principal Reduction	Carrying Amount
1/1/20X1	-	-	-	-	-	700,000
12/31/20X1	135,868	60,000	30,000	90,000	45,868	654,132
12/31/20X2	135,868	55,448	30,000	85,448	50,420	603,712
12/31/20X3	135,868	50,623	30,000	80,623	55,245	548,467
12/31/20X4	135,868	45,508	30,000	75,508	60,360	488,107
12/31/20X5	135,868	40,086	30,000	70,086	65,782	422,325
12/31/20X6	135,868	34,340	30,000	64,340	71,528	350,797
12/31/20X7	135,868	28,248	30,000	58,248	77,620	273,177
12/31/20X8	135,868	21,791	30,000	51,791	84,077	189,099
12/31/20X9	135,868	14,946	30,000	44,946	90,922	98,177
12/31/2030	135,868	7,691	30,000	37,691	98,177	-

Staff Research: Multiple Units of Account After Issuance

43. Debt instruments that are initially treated as a single unit of account upon issuance may, upon reassessment, require bifurcation. The staff has summarized the requirements for embedded features bifurcated after issuance below and has provided an overview of guidance on the modification of a conversion option that could cause it to be bifurcated after issuance in Appendix A.

Embedded Features Bifurcated After Issuance of Debt Instrument

44. Topic 815 requires that an entity continually reassess whether an embedded feature qualifies as a derivative or for a scope exception from the derivatives guidance. If an issued debt instrument contains an embedded feature that is later required to be bifurcated under Topic 815 (for example, because an embedded feature ceases to qualify for the conditions for equity classification in Subtopic 815-40),[9] the guidance in Topic 815 is not explicit about the adjustment necessary to the carrying amount of the host debt contract. EY Financial Reporting Developments, *Issuer's Accounting for Debt and Equity Financings (September 2024),* indicates that, in practice, there may be an adjustment to the carrying amount of the host debt instrument (which would affect the effective interest rate of that debt instrument).

> **2.4.3.3.2 Subsequent bifurcation**
>
> While ASC 815 requires the reassessment of certain embedded features (e.g., those linked to an entity's own equity) for potential bifurcation at each reporting date, it does not provide explicit guidance on how to bifurcate an embedded feature after the issuance date. We generally believe the most literal application of ASC 815 would be to bifurcate the embedded derivative as of the date it was required to be bifurcated at

[9] An entity may, for example, determine that it no longer has sufficient available authorized and unissued shares to settle an embedded feature in shares.

> its then-current fair value from the carrying amount of the host debt instrument. Other approaches also may exist. […]
>
> Any incremental discount or premium on the host instrument that results from the bifurcation would be amortized using the effective interest method over the remaining life of the instrument…. Because an unusual effective interest rate may result, other methods for accounting for a post-issuance bifurcation may result in a more reasonable effective interest rate.

Outreach

45. Five practitioners identified debt issued with detachable warrants as the most common source of significant differences between the effective interest rate and the contractual rate of interest. One practitioner noted the debt discount for these instruments is sometimes greater than 10 percent of the principal. Another practitioner noted the debt discount for these instruments is often between 10 percent and 15 percent.

46. Three other practitioners noted for startup or development-stage companies, the debt discount is often 20 percent or more for debt issued with detachable warrants. One of those practitioners noted that they encountered debt discounts between 30 percent and 50 percent somewhat frequently, and that they have also observed some scenarios in which the fair value of the warrants issued exceeded the amount of proceeds received. A different practitioner highlighted that the value of detachable warrants relative to the issuance proceeds varied significantly across debt issuances. They noted that issuers struggling to access financing were more likely to issue warrants with significant value together with a debt instrument.

47. While practitioners acknowledged that the separate recognition of an embedded derivative can also give rise to a debt discount, three practitioners noted that embedded derivatives do not cause significant debt discounts as frequently as debt issued with detachable warrants. By contrast, one practitioner indicated that certain embedded features (such as certain share-settled redemption features and change in control premiums) are sometimes recognized separately and can cause significant debt discounts.

48. One practitioner did not identify allocation of proceeds to multiple units of account as frequently giving rise to significant debt discounts.

Staff Research: Debt Discounts and Premiums Resulting from Initial Measurement at Fair Value

49. GAAP requires that some debt instruments be initially measured at fair value in connection with certain transactions. This section highlights the fair value initial measurement requirements in the following areas of GAAP:

    (a) Business Combinations and Other New Basis Events

    (b) Extinguishment Accounting under Subtopic 470-50

    (c) Certain Debt Issued for Nonfinancial Consideration (see Appendix A).

50. This section also provides an example to illustrate that initially measuring a debt instrument at fair value could give rise to a difference between the contractual interest rate of a loan and the loan's effective interest rate.

Business Combinations and Other New Basis Events

51. One area requiring initial measurement at fair value is the guidance in Subtopic 805-20, Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest. Paragraph 805-20-30-1 states that "the acquirer [in a business combination] shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values."[10]

52. Notably, the initial measurement guidance in Subtopic 805-20 also applies to other transactions that establish a new basis of accounting for an entity's assets or liabilities. Specifically, the guidance on pushdown accounting (Subtopic 805-50, Business Combinations—Related Issues), joint venture formations (Subtopic 805-60, Business Combinations—Joint Venture Formations), the acquisition of a variable interest entity (VIE) that does not meet the definition of a business (Topic 810, Consolidation), and fresh-start reporting (Topic 852, Reorganizations) all link to the requirements in Subtopic 805-20.

Extinguishment Accounting under Subtopic 470-50

53. Apart from business combinations, when extinguishment accounting is applied under Subtopic 470-50 following a modification or exchange, paragraph 470-50-40-13 states that the new debt instrument should be initially measured at fair value. This fair value amount is then used to determine both the recognized gain or loss on debt extinguishment and to calculate the effective interest rate of the new instrument.

Example: Initial Measurement at Fair Value Following Business Combination Accounting

54. A private company acquires another private company (that meets the definition of a *business*) that had previously issued a $1,000,000, 10-year amortizing loan with a contractual interest rate of 6 percent. The acquisition takes place exactly five years after the original issuance of the debt. During the 5-year period between issuance and acquisition, both the 10-year and 5-year risk-free interest rates have increased. In addition, credit spreads have widened. As a result of those market changes, the discount rate used to determine the fair value of the acquiree's debt at the acquisition date is now 12 percent.

55. Assuming that the loan is initially issued at par with no debt issuance costs, fees paid to the lender, or any other discount, the original amortization schedule (under both the interest method and the potential private company alternative) would be as follows.

[10] Appendix A includes a discussion of how the fair value of an assumed debt instrument may be determined in practice based on a review of firm publications and the AICPA Accounting and Valuation guide on business combinations.

Original Amortization Table (Debt Issued at Par):

Date	Payment	Interest Expense	Principal Reduction	Carrying Amount
1/1/20X1	-	-	-	1,000,000
12/31/20X1	135,868	60,000	75,868	924,132
12/31/20X2	135,868	55,448	80,420	843,712
12/31/20X3	135,868	50,623	85,245	758,467
12/31/20X4	135,868	45,508	90,360	668,107
12/31/20X5	135,868	40,086	95,782	572,325
12/31/20X6	135,868	34,340	101,528	470,797
12/31/20X7	135,868	28,248	107,620	363,177
12/31/20X8	135,868	21,791	114,077	249,099
12/31/20X9	135,868	14,946	120,922	128,177
12/31/20X0	135,868	7,691	128,177	-

56. On 1/1/20X6, the fair value of the acquiree's debt instrument is determined to be $489,774. Therefore, the acquirer (and also the acquiree, if it applies pushdown accounting) is required to calculate a new effective interest rate (in this case, 12 percent) to apply the interest method. The revised amortization table under the interest method would be as follows.

Post-Acquisition Amortization (Interest Method—12 percent effective interest rate):

Date	Payment	Interest Expense	Principal Reduction	Carrying Amount
1/1/20X5	-	-	-	489,774
12/31/20X6	135,868	58,773	77,095	412,678
12/31/20X7	135,868	49,521	86,347	326,332
12/31/20X8	135,868	39,160	96,708	229,624
12/31/20X9	135,868	27,555	108,313	121,311
12/31/20X0	135,868	14,557	121,311	-

57. However, if the potential private company alternative were applied to this fact pattern, the calculation of periodic interest expense, rather than being determined by reference to the 12 percent effective interest rate, would need to be calculated based on the contractual interest rate plus (or minus) the straight-line amortization of the remaining discount or premium necessary to make the loan amortize to zero. In this case, the amount to be amortized on a straight-line basis would equal $82,552 ($16,510 per year for five years) and would be calculated as the difference between:

(a) Undiscounted remaining payments ($679,340)

(b) The sum ($596,788) of:

(i) The carrying amount of the debt ($489,774)

(ii) The contractual interest to be recognized ($107,014).

58. The amortization table for the potential private company alternative would as follows.

Post-Acquisition Amortization (Potential Private Company Alternative):

Date	Payment	(A) Contractual Interest	(B) Amortization	(A) + (B) = Interest Expense	Principal Reduction	Carrying Amount
1/1/20X5	-	-	-	-	-	489,774
12/31/20X6	135,868	34,340	16,510	50,850	85,018	404,755
12/31/20X7	135,868	28,248	16,510	44,758	91,110	313,646
12/31/20X8	135,868	21,791	16,510	38,301	97,567	216,079
12/31/20X9	135,868	14,946	16,510	31,456	104,412	111,667
12/31/20X0	135,868	7,691	16,510	24,201	111,667	-

Outreach

59. Three practitioners noted that business combinations do not often create significant debt discounts or premiums. One practitioner noted that, in many private equity acquisitions, any existing debt is often extinguished (rather than assumed by the acquirer) and new debt is issued. A different practitioner emphasized that while they did not have comprehensive data on how significant debt discounts and premiums tend to be following a business combination, they noted that they did not expect that the discounts or premiums would typically exceed 10 percent of the principal to be repaid. Another practitioner indicated that the fair value of debt assumed in a business combination tends to be close to the debt's carrying amount, particularly when significant time has not elapsed between issuance and the acquisition date.

60. Some practitioners also noted that debt extinguishments do not often create significant debt discounts or premiums. One of those practitioners also noted that, consistent with past feedback, few debt modifications and exchanges accounted for as extinguishments under current GAAP.

61. By contrast, one practitioner noted that debt extinguishments can lead to significant debt discounts or premiums, particularly when there are changes in interest rates. That practitioner added that, while they do not encounter it as often, the same outcome is possible following a business combination because any assumed debt is also required to be initially measured at fair value.

62. One practitioner noted that the guidance for TDRs (when undiscounted cash flows are less than the carrying amount of the existing debt) can result in outcomes under which the effective interest rate becomes zero, but the instrument still pays contractual interest.

Staff Research: "Plain-Vanilla" and "Substantial Premiums and Discounts" in Topic 815

63. During the June meeting, the PCC discussed whether the potential private company alternatives should be limited to "simpler" debt instruments and referenced the amendments in Accounting Standards Update No. 2014-03, *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (a consensus of the Private Company Council)*. The amendments in Update 2014-13 provided for the use of a simplified hedge accounting approach to account for swaps that are entered into for the purpose of economically

converting a variable-rate borrowing into a fixed-rate borrowing. As part of deliberations in that project, the PCC discussed limiting application of the simplified hedging approach to "plain-vanilla" swaps.

> BC9. The PCC deliberated whether swaps other than "plain-vanilla" swaps should be allowed use of the simplified hedge accounting approach. The PCC decided to limit the simplified hedge accounting approach to a narrow set of circumstances such that the approach addresses the prevalent practice issue of a private company entering into a "plain-vanilla" receive-variable, pay-fixed interest rate swap for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing. As such, the PCC observed that use of other than "plain-vanilla" swaps may reflect more sophisticated structured financing arrangements that would not provide the sufficiently narrow set of circumstances to apply the simplified hedge accounting approach.

64. While the staff notes that there are several areas of GAAP that refer to types of "plain-vanilla" instruments,[11] the staff considered that the key effect of the potential private company alternative on an entity's financial reporting would be the timing of interest expense recognition (and the consequential effect on the carrying amount of a debt instrument). Therefore, rather than focusing on debt instruments that could arguably be considered "plain-vanilla" because they have simple terms but may be issued at a significant discount, the staff considered that it could be helpful for the PCC to evaluate exceptions that are based directly on the magnitude of a discount or premium.

65. That is, regardless of how complex or simple a debt instrument's terms are, the staff expects that if the debt discount or premium is insignificant, the effective interest rate is more likely to be similar to the contractual interest rate of the debt.[12] Accordingly, the staff has highlighted an existing area of guidance in which debt is assessed based on whether it contains a "substantial premium or discount."

66. Specifically, the phrase *substantial premium or discount* is used in Topic 815 on derivatives as part of guidance entities consider when determining whether call or put options that can accelerate the settlement of debt instruments should be considered clearly and closely related to the debt instrument.[13]

> **815-15-25-42** The following four-step decision sequence shall be followed in determining whether call (put) options that can accelerate the settlement of debt instruments shall be considered to be clearly and closely related to the debt host contract:
>
>> Step 3: Does the debt involve a substantial premium or discount? If yes, continue to Step 4. If no, further analysis of the contract under paragraph 815-15-25-26 is required, if applicable.

[11] These areas include Topic 325, Investments—Other, which refers to "plain-vanilla, variable-rate beneficial interest," and Topic 815, which refers to "plain-vanilla servicing rights," "plain-vanilla forward contracts," "plain-vanilla interest rate swap," and "'plain-vanilla' swap." This excludes any guidance applicable to public business entities that is issued by the SEC and SEC staff.

[12] The staff acknowledges that the term of a debt instrument also influences the extent to which the effective interest rate and its contractual rate will differ when there is a discount or premium.

[13] In accordance with paragraph 815-15-25-1, an embedded derivative is required to be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.

67. The staff notes that, while no bright line is provided in the Codification,[14] firm publications describe this guidance as follows.[15]

Firm Publication	Excerpt
PwC (Guide to Financing Transactions)	Practice generally considers a discount or premium equal to or greater than 10% of the par value of the host debt instrument to be substantial.…However, a 10% discount or premium is not a bright-line; all relevant facts and circumstances should be considered to determine whether the discount or premium is substantial….
Deloitte (Issuer's Accounting for Debt)	In practice, a discount or premium that is 10 percent or more is considered "substantial" in the analysis performed under step 3.
KPMG (Debt and Equity Handbook)	We believe that a substantial premium or discount should be interpreted as a premium or discount that is 10% or greater of the amount allocated to the hybrid instrument when the instrument is originally recognized, compared to its payoff amount.
EY (Issuer's accounting for debt and equity financings)	There is no authoritative guidance on what constitutes a substantial premium or discount. However, ASC 470-50-40-10 describes debt that is substantially different based on at least a 10% difference in cash flows on a present value basis. By analogy to the term "substantially different" in that guidance, some have argued that if a premium or discount (as discussed above) is approximately 10% or more of the principal amount of the note, it is substantial. This determination should be based on the specific facts and circumstances and requires professional judgment.

Outreach: Practitioner Perspectives on Scope

Whether to Provide a Scope Exception

68. Overall, feedback was mixed on whether there should be a scope exception to the potential private company alternative to limit its applicability to certain debt instruments.

69. Three practitioners expressed a preference for not permitting the application of the private company alternative to debt instruments that are issued with a significant[16] discount or premium. One of those practitioners stated that although they did not support the potential private company alternative in general, if a potential private company alternative were codified, then they would prefer a narrower scope to a broad scope. Two practitioners indicated that while they were concerned that a complex

[14] The term *substantial premium* was used in APB 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. The term *substantial discount or premium* in Topic 815 originated in Statement 133 Implementation Issue B16, *Calls and Puts in Debt Instruments*. Neither of those documents contained a basis for conclusions discussion that described what should be considered "substantial."

[15] The staff also notes that the term *substantial premium* is used in Topic 470 on convertible debt instruments. The staff understands that practitioners interpret what constitutes "substantial" under that guidance similarly to how they interpret the guidance included in Topic 815.

[16] In this memo, the term *significant* is intended to be generic and is not intended to necessarily have the same meaning as the term "substantial" (as that term is used in Topic 815).

scope could diminish any benefits of a private company alternative to the interest method, they supported prohibiting application of the potential private company alternative in scenarios in which debt is issued at a significant discount or premium.

70. One practitioner indicated that there should be no scope exceptions if the potential private company alternative were applied. They noted that limiting the scope of the potential alternative would result in private companies applying multiple loan amortization methods simultaneously and that they were uncertain whether users would benefit from continuing to require the interest method, even for instruments that are issued at a significant discount or premium. For example, they noted that, for their client-base of private equity portfolio companies, the metric that receives the most attention is EBITDA, and this metric would generally be unaffected by application of the potential private company alternative. However, this practitioner also indicated that their views would be influenced by any user feedback on whether the interest method provides for decision-useful information.

71. One practitioner expressed operability concerns with each of the potential alternatives for scope exceptions. Like other practitioners, they expressed concerns that scope exceptions would cause the potential private company alternative to be more difficult to apply than existing guidance. However, this practitioner also noted that if no scope exceptions were provided, there would be a significant risk of structuring under the potential private company alternative. Therefore, this practitioner expressed skepticism about whether it would be feasible to develop a private company alternative to the interest method that is simpler than the current guidance (which permits exceptions to the interest method if the results are not materially different).

72. One practitioner provided mixed feedback on potential alternatives on scope exceptions. Some representatives from this practitioner firm indicated that there should be no scope exceptions and indicated that establishing any scope exceptions risked creating guidance that is more complex than existing GAAP. Other members of this practitioner firm indicated that they preferred to limit the scope of a potential private company alternative to avoid significantly changing financial reporting outcomes. This practitioner also highlighted that a better understanding of the PCC's objective in pursuing potential changes to this guidance would influence their views on a potential scope.

Specific Scope Exceptions

73. During outreach, practitioners generally did not express support for establishing specific scope exceptions based on whether debt instruments were initially measured at fair value or whether the proceeds upon issuance were allocated to multiple units of account.

74. One practitioner noted that an entity could allocate proceeds to multiple instruments and one of the instruments could be both immaterial but technically meet a threshold to be recognized separately. In those scenarios, that practitioner questioned whether the mere fact that proceeds were allocated to the immaterial instrument should preclude the application of the potential private company alternative.

75. Similarly, another practitioner indicated that a broader scope exception (for example, one based on whether debt is issued with a *substantial premium or discount*) would be simpler to apply than a narrow scope exception that identifies specific types of instruments that would not be eligible for the potential private company alternative.

76. A different practitioner expressed concern that a scope exception comprising a detailed list would cause preparers to continue current practice without giving consideration to the potential private company alternative. That practitioner indicated that it might be preferable to explore a qualitative description of what constitutes a "plain-vanilla debt instrument" rather than provide a detailed list of debt instruments not eligible to apply the potential private company alternative.

Substantial Premium or Discount

77. While some practitioners indicated that a broad scope exception based on the phrase *substantial premium or discount* would be preferable to narrow scope exceptions, mixed feedback was received about the potential operability of the phrase *substantial premium or discount*.

78. Several practitioners indicated that without clarifications, it may not be clear whether an instrument would be issued with a "substantial premium or discount" if it resulted in a significant amount that would be subject to straight-line amortization under the potential private company alternative. Said differently, for certain instruments that are accounted for as debt but have no contractually stated interest rate, those practitioners questioned whether practice would consistently conclude that such instruments are issued at a substantial discount without additional implementation guidance.

79. One practitioner expressed concerns that preparers may not consistently interpret the term *substantial.*

80. A few practitioners did not express concern that there would be difficulty interpreting the phrase *substantial premium or discount.*

Bright-Line Threshold

81. During the course of outreach, in response to feedback received on using the term *substantial premium or discount,* the staff solicited feedback on whether a bright line threshold should address some of the challenges identified with leveraging the term *substantial premium or discount.*

82. Two practitioners who did not support any scope exceptions indicated that the term *substantial premium or discount* could be preferable to a potential bright-line requirement because of the risk of structuring around a bright-line or because a bright-line was expected to be more complex to apply. By contrast, a different practitioner indicated that a bright line (such as 10 percent) could be preferable to leveraging the term *substantial premium or discount* and could help simplify the analysis of whether a debt instrument would be eligible to apply the potential private company alternative.

Staff Analysis

Whether to Provide a Scope Exception

83. While the staff highlights mixed feedback about the need for a narrower scope, it is concerned that permitting application of the potential private company alternative to debt instruments issued at a significant discount or premium would diminish the decision-usefulness of the accounting for debt instruments while providing only modest reductions in costs to private company preparers and auditors. On the basis of the examples provided in this memo, the staff has summarized the key effects that the private company alternative would have on the accounting for debt instruments that are issued at a significant discount or premium.

	Interest Method	**Potential Private Company Alternative**
Carrying Amount	Generally, reflects the present value of remaining payments discounted at the effective interest rate.	Would not reflect a present value calculation based on the entity's borrowing rate.
Periodic Interest Expense	Proportional to the carrying amount of the loan and reflects an entity's cost of borrowing each period (for example, conveys that borrowing a large amount is more costly than borrowing a small amount).	Would not be directly related to the carrying amount of a loan and would not meaningfully reflect an entity's cost of borrowing in any given period (the amount would only be meaningful if accumulated across the entire loan term).
Structuring	Treats cash flows labeled as interest and principal repayments (which are fungible) identically and is less susceptible to structuring.	Differentiates cash flows based on how those cash flows are labeled in an agreement. Some stakeholders indicated this would be susceptible to structuring.

84. The staff thinks that each of these concerns could be mitigated by limiting the population of debt instruments to which any potential private company alternative is applied. That is, in scenarios in which there is not a significant discount or premium because the contractual rate approximates the effective interest rate, the meaningfulness of an entity's accounting for debt instruments would not be as significantly diminished. Moreover, the risk of structuring would also be reduced if the private company alternative could only be applied when the contractual rate represented a reasonable approximation of the effective interest rate.

85. The staff acknowledges feedback that a narrow scope could add complexity and be more challenging to apply than the interest method. It may also duplicate current guidance, which already allows alternatives when differences are immaterial. However, if the challenges associated with applying and auditing the interest method are significant enough to justify a private company alternative, then the staff would expect that any challenges associated with navigating a narrow scope would be less significant by comparison.

Approaches

Specific Scope Exceptions

86. The staff agrees with feedback from practitioners that establishing a list of the various types of debt instruments not eligible to apply the potential private company alternative (such as instruments that are bifurcated, issued with warrants, or initially measured at fair value) could create complexity and could lead to unintuitive outcomes. For example, under this approach, a debt instrument with an embedded feature that is clearly immaterial and recognized separately may not qualify for the potential private company alternative, even if applying the alternative would not significantly impact financial reporting outcomes in this situation.

Broad Scope Exception 1 (Substantial Premium or Discount)

87. Although the staff thinks that leveraging guidance from Topic 815 on debt instruments with a "substantial premium or discount" could address concerns about financial reporting outcomes while leveraging existing guidance, it acknowledges the operability concerns raised by some practitioners.

88. The staff also thinks that some private company preparers and practitioners (particularly those not familiar with the derivatives guidance in Topic 815) could find the term *substantial* to be ambiguous. The staff also thinks that leveraging guidance identical to that found in Topic 815 could present standard-setting challenges because it could be difficult to clarify or provide implementation guidance for this phrasing without inadvertently affecting interpretations of the existing derivatives guidance.

Broad Scope Exception 2 (10 Percent Bright Line)

89. On the basis of the outreach feedback received, the staff has developed another approach that offers more detailed guidance than what is currently provided in Topic 815 on instruments with a substantial premium or discount. This approach would use an explicit 10 percent threshold instead of the term *substantial*. Additionally, instead of evaluating whether a debt instrument has a substantial premium or discount consistent with the guidance in Topic 815, a private company would determine whether the total amount to be amortized on a straight-line basis is greater than 10 percent of total undiscounted cash payments.

90. To illustrate this approach, assume Private Company P enters a sale-of-future-revenue arrangement that, under current guidance, would be accounted for as debt by applying the interest method. Private Company P receives cash proceeds of $5 million at issuance and under the interest method, would create the following amortization schedule based on the proceeds received and the estimated future cash payments (it calculates an effective interest rate of 13.14 percent).

Sale of Future Revenue Example—Interest Method

Date	Estimated Payment	Preliminary Interest Expense	Preliminary Principal Reduction	Preliminary Carrying Amount
1/1/20X5	-	-	-	5,000,000
12/31/20X6	1,000,000	657,068	342,932	4,657,068
12/31/20X7	1,000,000	612,002	387,998	4,269,069
12/31/20X8	1,500,000	561,013	938,987	3,330,082
12/31/20X9	2,000,000	437,618	1,562,382	1,767,700
12/31/20X0	2,000,000	232,300	1,767,700	-
Total	**7,500,000**	**2,500,000**	**5,000,000**	**N/A**

91. Because there is no contractual interest to be paid in this example, under the potential private company alternative, the entire amount of interest ($2,500,000) would be amortized on a straight-line basis as follows.

Sale of Future Revenue Example—Potential Private Company Alternative

Date	Estimated Payment	(A) Contractual Interest	(B) Estimated Amortization	(A) + (B) = Estimated Interest Expense	Estimated Principal Reduction	Estimated Carrying Amount
1/1/20X5	-	-	-	-	-	5,000,000
12/31/20X6	1,000,000	-	500,000	500,000	500,000	4,500,000
12/31/20X7	1,000,000	-	500,000	500,000	500,000	4,000,000
12/31/20X8	1,500,000	-	500,000	500,000	1,000,000	3,000,000
12/31/20X9	2,000,000	-	500,000	500,000	1,500,000	1,500,000
12/31/20X0	2,000,000	-	500,000	500,000	1,500,000	0
Total	**7,500,000**	**-**	**2,500,000**	**2,500,000**	**5,000,000**	**N/A**

92. Under this method, a private company would calculate the total amount to be amortized straight-line (in this example, $2,500,000 total in Column B) and compare it to the total undiscounted payments ($7,500,000) to determine if the quotient exceeds 10 percent. In this instance, since the total amount to be amortized straight-line would equal 33.3 percent of the undiscounted total payments (2,500,000 ÷ 7,500,000), the instrument would not be eligible for the potential private company alternative.

93. The staff notes that a bright-line requirement may be clearer than the phrase *substantial premium or discount*. However, the staff also recognizes that some stakeholders may not support establishing a bright line and/or creating a new threshold specifically for the purpose of applying a potential private company alternative to the interest method.

Interaction with the Guidance on Modifications, Extinguishments, and TDRs

Subtopic 470-50 (Modifications and Extinguishments)

Staff Research

94. The interest method and calculating the effective interest rate are required aspects of applying the guidance under Subtopic 470-50. Therefore, permitting an entity to adopt the potential private company alternative could affect how the guidance in Subtopic 470-50 is applied. Said differently, although determining the effective interest rate of the original debt is necessary when applying both the interest method and the guidance in Subtopic 470-50, it would not be needed to apply the potential private company alternative. Therefore, without additional specific guidance, there could be questions about whether an entity applying the potential private company alternative would still be required to calculate an effective interest rate to apply the guidance in Subtopic 470-50.

Use of the Original Debt's Effective Interest Rate in the 10 Percent Test

95. The 10 percent test requires an entity to use the effective interest rate of the original debt instrument to determine the present value of cash flows for both the original and modified (or exchanged) debt. Under this guidance, if the difference between the present value of the remaining cash flows under the original terms and the cash flows under the modified instrument is less than 10 percent, modification accounting is applied; if the difference is greater than or equal to 10 percent, extinguishment accounting is required.

How the Method of Discount or Premium Amortization Affects Outcomes under Subtopic 470-50

96. The method used to amortize a discount or premium directly affects the carrying amount of the original debt instrument before it is modified or exchanged. The resulting carrying amount, in turn, affects financial reporting outcomes when the guidance in Subtopic 470-50 is applied in the following ways.

    (a) If modification accounting is applied, the original debt's carrying amount carries forward to the new debt instrument and influences the effective interest rate of the modified or exchanged debt because a new effective interest rate is determined by solving for the discount rate that causes the present value of the modified cash flows to equal the carrying amount of the original debt instrument. The staff also highlights that the interest method would be used under current guidance after modification accounting is applied; if the potential private company alternative were applied prior to a modification or exchange, there could be questions about whether it would be permitted following the application of modification accounting.

    (b) If extinguishment accounting is applied, the original debt's carrying amount affects the calculation of the gain or loss on extinguishment.

    (c) The carrying amount of the original debt instrument affects the calculation used to determine whether the modification of a conversion option requires modification accounting or extinguishment accounting. The change in the fair value of the conversion option is divided by the original debt instrument's carrying amount; if the change equals or exceeds 10 percent of the original debt's carrying amount, extinguishment accounting is applied (if it is less than 10 percent, modification accounting is applied).

Outreach Summary

Existing Practice

97. Practitioners provided mixed feedback on how the guidance in Subtopic 470-50 is applied currently when private companies use the straight-line method to amortize debt instruments. Three practitioners indicated that they did not have direct visibility into how the guidance is currently being applied. Two of those practitioners speculated that when the straight-line method is applied, entities are most likely using the existing carrying amount and calculating the effective interest rate for the original debt instrument based on that carrying amount (rather than going back to the beginning of the loan and calculating the effective interest rate consistent with Topic 835).

98. Several practitioners highlighted that, in many cases, there is not a significant effect because many debt instruments have prepayment features that result in modification accounting following the application of the 10 percent test. One practitioner observed that in instances in which prepayment provisions do not automatically trigger modification accounting, there is variability in practice. That practitioner noted that some entities used the carrying amount at the loan's inception and recalculated the effective interest rate while others calculated a new effective interest rate based on the loan's current carrying amount.

99. One practitioner indicated that they are not aware of their clients pervasively using the straight-line method.

Consequential Amendments for Entities Applying the Potential Private Company Alternative

100. Two practitioners indicated that they did not agree with revising the guidance in Subtopic 470-50 in any way to accommodate entities applying the potential private company alternative.

101. Three practitioners noted that they did not support making significant changes to the guidance in Subtopic 470-50 specifically to accommodate an alternative to the interest method. Those practitioners indicated that they would prefer a narrower approach in which an entity is permitted to calculate the original debt instrument's effective interest rate based on the debt's carrying amount immediately before a modification or exchange. One practitioner indicated that any significant changes to the guidance in Subtopic 470-50 should be considered as part of a project that specifically considers issues in the debt modifications guidance. Similarly, two practitioners questioned whether it would be reasonable to require an entity applying the potential private company alternative to retrospectively recalculate the original effective interest rate as if it had always applied the interest method.

102. A different practitioner indicated that entities adopting the potential private company alternative should be allowed to use the contractual rate instead of the effective interest rate of the original debt instrument because it would make the guidance simpler to apply and would be consistent with the requirements under the potential private company alternative. However, a practitioner who did not support this approach indicated it could create, rather than alleviate, complexity because it would create alternative options in applying Subtopic 470-50 that do not exist in current practice.

Staff Analysis

103. On the basis of its current research (including outreach), the staff thinks that any changes to the guidance in Subtopic 470-50 should be limited to allowing an entity to calculate the effective interest rate prospectively using the existing carrying amount when applying the 10 percent test. That would avoid entities having to retrospectively apply the interest method following a modification or exchange while generally minimizing changes to outcomes under Subtopic 470-50.

104. The staff thinks that using the contractual interest rate instead of the original debt's effective interest rate could affect outcomes under the 10 percent test in ways that are unrelated to the economics of the modification or exchange. For example, when a debt instrument is issued at a significant discount, discounting original and modified cash flows at an artificially low contractual rate could understate the financial effect of delaying or accelerating cash repayments. However, the staff acknowledges that if the overall scope of the potential private company alternative were narrow (specifically, if it was limited to instruments that have contractual interest rates that approximate their effective interest rates), then the staff would expect that there would be less pressure on whether the effective interest rate or the contractual interest rate is used.

Subtopic 470-60 TDRs

Staff Research

105. Certain aspects of applying the interest method, such as calculating an effective interest rate, are also part of the guidance related to TDRs.

106. For example, entities may be required to calculate effective interest rates to determine if a transaction should be accounted for as a TDR or is instead subject to other GAAP, such as Subtopic 470-50. A transaction is accounted for as a TDR only if the creditor has granted a concession. A creditor is deemed to have granted a concession when debtor's effective interest rate on the restructured debt is less than the effective interest rate of the original debt immediately before the restructuring. The effective interest rate of the restructured debt is calculated by projecting all cash flows under the new terms and determining the discount rate that equates the present value of these cash flows to the issuer's carrying amount of the original debt.

107. Additionally, for a transaction that is deemed to be a TDR involving only a modification of terms of a payable, if the total (undiscounted) future cash payments exceed the debt's carrying amount, paragraph

470-60-35-5 requires the application of an approach that it describes as "in substance the interest method." That approach requires the calculation of a new effective interest rate to equate the future cash flows to the debt's existing carrying amount. The characterization of those future payments as interest or principal does not affect the required accounting.[17]

Outreach

108. Practitioners' feedback on the guidance in Subtopic 470-60 generally aligned with their feedback on the guidance in Subtopic 470-50. While some practitioners noted that troubled debt restructurings are less common than debt modifications and exchanges accounted for under Subtopic 470-50, some who did not support significant changes to the Subtopic 470-50 guidance similarly did not support significant changes to the Subtopic 470-60 guidance for determining whether a concession has been granted. Others who supported permitting the use of the original debt's contractual rate in Subtopic 470-50, also supported using the contractual rate in place of the original debt's effective rate under Subtopic 470-60. However, a different practitioner who was open to narrow changes in Subtopic 470-50 indicated that while they thought overall changes to Subtopic 470-60 should considered as part of a broader project, they did not support any changes specifically to accommodate the potential private company alternative.

109. One practitioner indicated that the existing guidance in Subtopic 470-60 may already be sufficient to accommodate a potential private company alternative. They noted that Subtopic 470-60 refers to calculating effective interest rates based on the carrying amount of the existing debt instrument without specifying how that carrying amount should be determined. That practitioner also indicated that consideration should be given to eliminating the TDR guidance in Subtopic 470-60 as part of a broader project.

Staff Analysis

110. Consistent with the staff's analysis on Subtopic 470-50, the staff thinks that changes, if any, to the guidance in Subtopic 470-60 to accommodate a potential private company alternative to the interest method should be limited to explicitly allowing an entity to calculate the effective interest rate prospectively using the existing carrying amount when determining whether a concession has been granted.

111. While one practitioner supported permitting an entity to use the contractual rate of the original debt in place of its effective borrowing rate when determining whether a concession has been granted, the staff

[17] If the total future undiscounted cash payments specified by the revised terms of a payable (including both those allocated to interest and principal) are less than the carrying amount of the payable, the debtor must reduce the carrying amount to equal the total future cash payments under the new terms. That adjustment is recognized as a gain in the amount of the reduction. Subsequent cash payments are treated solely as reductions of the carrying amount, with no interest expense recognized between the date of restructuring and the maturity of the payable. As a result, the debt amortization approaches described in this memorandum—such as the interest method or the potential private company alternative—would not affect financial reporting outcomes in these cases.

has concerns about the outcomes and costs and benefits of this approach. Specifically, the staff highlights the following two potential issues with that approach.

(a) Depending on the scope of the potential private company alternative, the contractual rate may not represent a reasonable approximation of the effective interest rate. That could create highly unintuitive outcomes (as well as an “apples to oranges” comparison with the effective rate of the restructured debt). To illustrate, if that change were made, then it would only be possible to conclude that a concession has been granted on a zero-coupon note if the effective borrowing rate of the restructured note is negative.

(b) An entity would still be required to calculate the effective borrowing rate of the restructured debt which would potentially diminish any benefits from making changes to this guidance. That is, an entity applying the potential private company alternative would still need to calculate an effective interest rate based on the existing debt’s carrying amount.

Consideration of Agenda Consultation Feedback

Staff Analysis

112. The staff thinks it is important to consider any potential significant changes to the guidance in Subtopics 470-50 and 470-60 in the context of the recent agenda consultation feedback on those areas. For example, the staff highlights that although this memo considers changes to Subtopics 470-50 and 470-60 specifically to accommodate the potential private company alternative to the interest method, broader feedback was received on those areas of guidance. The staff also notes that no substantial feedback in response to the Agenda Consultation was received on challenges encountered when applying the interest method to issued debt instruments.

Staff Research: Special Debt Accounting Models

113. The staff notes that there are several specialized areas of guidance on the subsequent measurement of debt instruments for which consequential amendments or specific scope exceptions could be considered if the PCC pursues the potential private company alternative. The staff has summarized those areas below and would plan to provide additional analysis on those areas at a future meeting. The staff notes that the extent to which some of those areas would require consequential amendments could be affected by how broadly the potential private company alternative would apply. That is, a broader scope could require consideration of more of these areas, while a narrower scope could preclude the need to consider certain areas.

Special Area	Considerations
Sales of Future Revenue (Accounted for as Debt)	The Codification provides guidance for sales of future revenue accounted for as debt (rather than as deferred income) and requires that the interest method be applied (see paragraph 470-10-35-3), which can involve solving for an effective rate that equates

Special Area	Considerations
	the instrument's carrying amount to the present value of the future cash flows to be paid. However, there may not be a contractual interest rate in such arrangements.
Variable Rate Debt	The Codification does not contain explicit guidance on applying the interest method to variable or floating rate debt that is specifically directed at the debt issuer. However, some firm publications (for example, Deloitte's guide on the *Issuer's Accounting for Debt*) indicate that entities may analogize to the requirements applicable to a lender in paragraph 310-20-35-18(c).
Increasing Rate Debt	Paragraph 470-10-35-1 states that "a debt instrument may have a maturity date that can be extended at the option of the borrower at each maturity date until final maturity. In such cases, the interest rate on the note increases a specified amount each time the note is renewed." Paragraph 470-10-35-2 states that "the borrower's periodic interest cost shall be determined using the interest method based on the estimated outstanding term of the debt. In estimating the term of the debt, the borrower shall consider its plans, ability, and intent to service the debt. Debt issue costs shall be amortized over the same period used in the interest cost determination."
Indexed Debt	Topic 470 provides guidance on "indexed debt," which are debt instruments that are issued with both guaranteed and contingent payments (based on, for example, the price of a specific commodity, such as oil, or a specific index, such as the S&P 500). Paragraph 470-10-25-4 states that "if the investor's right to receive the contingent payment is separable, the proceeds shall be allocated between the debt instrument and the investor's stated right to receive the contingent payment. The premium or discount on the debt resulting from the allocation shall be accounted for in accordance with Subtopic 835-30." When no proceeds are initially allocated to the contingent payment, an additional liability resulting from the fluctuating index value is accounted for as an adjustment of the carrying amount of the debt obligation. However, some firm publications highlight that many features that would be within the scope of this guidance are accounted for as bifurcated derivatives under Topic 815. For example, EY publication: *Financial Reporting Developments, Issuer's Accounting for Debt and Equity Securities*, states that "because these features typically meet the definition of a derivative and generally do not qualify for any exceptions, they are often bifurcated."
Callable and Puttable Debt	Firm publications provide interpretative guidance on estimating the amortization period of callable and puttable debt (see EY Financial Reporting Developments*, Issuer's Accounting for Debt and Equity Financings,* Sections 2.4.3.1 and Deloitte, *Issuer's Accounting for Debt,* Sections 6.2.3.4 and 6.2.4.4*)*

Outreach

114. During outreach, the staff asked whether there were specific areas that would require additional guidance if the potential private company alternative to the interest method were permitted.

115. One practitioner indicated that without specific guidance, it may be unclear how to apply the potential private company alternative to debt instruments with variable cash flows. For example, they noted that it may need to be clarified how changes to the interest rate in variable rate debt would be reflected by entities applying the potential private company alternative.

116. Another practitioner indicated that there is broader need for more guidance on variable rate debt, particularly if fewer debt instruments with variable cash flows have embedded features that are

accounted for as derivatives (as was proposed in Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606)—Derivatives Scope Refinements and Scope Clarification for a Share-Based Payment from a Customer in a Revenue Contract*).

117. One practitioner stated that to minimize complexity, if an alternative to the interest method were provided, there should not be exceptions for (or additional guidance on) any specific types of debt instruments. However, that practitioner also indicated that, if a potential private company alternative were pursued, then the PCC should consider whether to provide consequential amendments on the statement of cash flows guidance for debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate. Specifically, they noted that without additional guidance, it might be unclear whether there is a need to calculate an effective interest rate to apply the statement of cash flows guidance, even if an entity would otherwise not need to calculate the effective interest rate to apply the potential private company alternative to the interest method.

118. One practitioner did not identify any specific areas that required consequential amendments if the potential private company alternative were permitted.

Income Taxes

Staff research

119. The staff highlights the requirements in Topic 740, Income Taxes, that an entity recognize a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards.

120. While previous documents prepared for the PCC have focused on the GAAP requirements for calculating interest expense, the staff notes that separate requirements in the Internal Revenue Code (and relevant regulations) would apply for federal income tax purposes.

Overview of Discount Amortization for Federal Income Tax Purposes

121. A March 2025 article published by *The Tax Adviser* (an AICPA publication) provides an overview of the requirements for calculating the interest deduction for federal income tax purposes.[18] That article highlights that while "in practice, taxpayers may use their interest expense for accounting purposes as a proxy for their interest expense for tax purposes…taxpayers who assume that their interest expense computed for accounting purposes is the same as their interest expense for tax purposes may be surprised to learn that there are distinct differences between the two."

[18] https://www.thetaxadviser.com/issues/2025/mar/a-closer-look-at-the-costs-of-borrowing/

122. The Tax Adviser Article highlights various requirements in the Internal Revenue Code. It also discusses the requirements for loan amortization.

> **Original issue discount**
>
> Under Sec. 1273(a)(1), OID is the excess, if any, of the stated redemption price at maturity over the issue price. OID is generally taken into account by the borrower following rules in Regs. Sec. 1.163–7, *which generally require the use of the constant–yield method* (described in Regs. Sec. 1.1272–1(b)) to compute how much OID is deductible for a period. *Special rules may apply if the total amount of OID on the debt is de minimis, which may allow the borrower to deduct OID over the term of the debt based on a straight–line amortization method*. [Emphasis added.]

123. Sec. 1.1273-1 (Definition of OID) provides the following guidance.[19]

> ***(d) De minimis OID—***(1) *In general*. If the amount of OID with respect to a debt instrument is less than the de minimis amount, the amount of OID is treated as zero, and all stated interest (including stated interest that would otherwise be characterized as OID) is treated as qualified stated interest.
>
>> ***(2) De minimis amount.*** The de minimis amount is an amount equal to 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date.

124. The Tax Adviser Article also provides the following discussion of debt issuance costs.

> **Debt issuance costs**
>
> For tax purposes, the term "debt issuance costs" means transaction costs incurred by an issuer of debt that are required to be capitalized under Regs. Sec. 1.263(a)-5 (Regs. Sec. 1.446–5(a)). Pursuant to Regs. Sec. 1.263(a)-5(a)(9), a taxpayer must capitalize an amount paid to facilitate a borrowing as debt issuance costs. Debt issuance costs are generally capitalized and amortized over the term of the debt instrument to which the costs relate (Enoch, 57 T.C. 781 (1972)) and typically include underwriting costs, commissions, legal services, and other costs related to the issuance of a debt.
>
> Prior to the issuance of Regs. Sec. 1.446–5, debt issuance costs were deductible over the term of the debt based on a straight–line amortization method. However, Regs. Sec. 1.446–5, while issued to conform the rules for debt issuance costs to the rules for OID, applies solely for purposes of determining the deduction of debt issuance costs in a given period. Under Regs. Sec. 1.446–5(b), the issuer treats debt issuance costs "as if they adjusted the yield on the debt" by treating the costs "as if they decreased the issue price of the debt." If the aggregate of OID and debt issuance costs are de minimis, the borrower may deduct the debt issuance costs over the term of the debt based on a straight–line amortization method.

125. Finally, the Tax Adviser Article concludes with the following discussion of the GAAP requirements compared to the income tax requirements:

> …taxpayers should evaluate the methods for determining interest expense for accounting purposes to determine whether they are permissible methods for tax purposes. The timing of items classified as interest expense for accounting purposes may be different from the timing for tax purposes. For example, while the interest method for accounting purposes may be similar to the constant–yield method, the straight–line method for OID and debt issuance costs may be used for accounting purposes under certain circumstances. Similarly, the straight–line method or other

[19] https://www.govinfo.gov/content/pkg/CFR-2024-title26-vol13/pdf/CFR-2024-title26-vol13-sec1-1273-1.pdf

methods may be permissible for tax purposes under certain circumstances. Given that alternative methods for amortizing OID and debt issuance costs may be permissible for tax purposes, depending on the circumstances, taxpayers should assess their circumstances for determining appropriate accounting methods for tax purposes.

Detachable Warrants, Bifurcated Derivatives, and Debt Modifications and Exchanges

126. The staff has provided a brief summary of the guidance provided by practitioners on the income tax accounting effect of detachable warrants, bifurcated derivatives, and debt modifications and exchanges in Appendix B. At a high level, the staff notes that there are differences in the financial reporting and tax reporting requirements in each of these areas that can give rise to temporary differences (and to the recognition of deferred tax assets or liabilities).

Outreach

127. Although not all practitioners provided feedback on how the potential private company alternative would affect the accounting for income taxes, those that did indicated that a potential private company could create new differences between GAAP and income tax requirements that could lead to temporary differences for simple debt instruments. For example, one practitioner noted that the potential private company alternative could create new differences even for “plain-vanilla” debt instruments. Similarly, another practitioner, noted that, based on conversations with its firm’s tax specialists, they expected that the potential private company alternative could result in recognition of deferred tax assets because of the tax requirements related to using the effective yield method.

128. Two other practitioners noted that since differences already exist between GAAP and tax requirements for debt instruments, additional changes to GAAP are unlikely to result in significant challenges in practice. For example, one practitioner emphasized that certain areas of the tax code, such as the limitations on the deductibility of interest, already result in temporary differences. Therefore, they noted that the potential private company alternative is expected to have no effect on the process of determining the appropriate deferred tax assets and liabilities to recognize, even if it affects the amounts that are recorded.

Next Steps

129. The staff will seek direction from the PCC on next steps during the September 2025 PCC meeting. If the PCC continues to pursue the potential private company alternative, the staff will plan to conduct outreach with private company financial statement users to better understand their perspectives.

Appendix A: Summary of Other Research on Specialized Areas of Debt Accounting

A1. This Appendix provides additional information on certain research areas mentioned elsewhere in this memo. The sections in this Appendix are organized as follows.

(a) Participating Mortgages (Lender is Entitled to Participate in Appreciation of Market Value)

(b) Modification of a Conversion Option (Bifurcation of a Debt Instrument After Issuance)

(c) Certain Debt Issued for Nonfinancial Consideration

(d) Additional Background on Valuation of Debt Instruments in a Business Combination

Participating Mortgages (Lender is Entitled to Participate in Appreciation of Market Value)

A2. One area requiring the recognition of a separate feature upon issuance (resulting in an allocation of proceeds), is addressed by the guidance for participating mortgages in Subtopic 470-30, Debt—Participating Mortgages. This guidance distinguishes between arrangements in which the lender is entitled to participate (a) in the appreciation of the fair value of the mortgaged real estate project or (b) in the results of operations of the mortgaged real estate project. When the lender participates in the appreciation of the project's fair value, the borrower must allocate the proceeds received to the participation feature.[20, 21]

A3. Paragraph 470-30-25-1 states that "if a lender is entitled to participate in the appreciation of the market value of a mortgaged real estate project, the borrower shall recognize a participation liability with a corresponding debit to a debt discount account." The participation liability is remeasured at fair value each period, with changes fair value recognized through the debt discount (paragraph 470-30-35-4A).

A4. The debt discount is amortized prospectively using the interest method (paragraphs 470-30-35-1 and 470-30-35-5), and this amortization is included in interest expense (paragraph 470-30-45-1).

Modification of a Conversion Option (Bifurcation of a Debt Instrument after Issuance)

A5. Topic 470, after the effective date of Accounting Standards Update No. 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*, does not typically require separate recognition of embedded conversion features unless bifurcation and separate recognition as a derivative are necessary (or the convertible debt is issued at a substantial premium). However, under the Subtopic 470-50 guidance on debt modifications and

[20] Firm publications (for example, Deloitte's guide on *Issuer's Accounting for Debt Instruments*, section 7.3.2) highlight that the participation feature is typically not required to be accounted for as a derivative under Topic 815 because the guidance in paragraph 815-10-15-39 scopes out "the price or value of a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash" and "specified volumes of sales or service revenues of one of the parties to the contract."

[21] This guidance does not require separation of a participation liability when the lender is entitled only to participate in the results of operations of the mortgages real estate project.

extinguishments, a conversion feature may need to be bifurcated after issuance. Paragraph 470-50-40-15 states, if modification accounting is used (rather than extinguishment accounting) because the original and new debt instruments are not substantially different, any increase in the fair value of an embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) reduces the carrying amount of the debt instrument (increasing a debt discount or reducing a debt premium) with a corresponding increase in additional paid-in capital. A reduction to the carrying amount of the debt could create a difference between the effective interest rate and the contractual rate of interest.

Certain Debt Issued for Nonfinancial Consideration

A6. Subtopic 835-30 states that business transactions often involve exchanging cash, property, goods, or services for a note or similar instrument. In an arm's length transaction where a note is exchanged for property, goods, or services, paragraph 835-30-05-2 states that there is a "general presumption that the rate of interest stipulated by the parties to the transaction represents fair and adequate compensation to the supplier for the use of the related funds." However, it also notes that this presumption should not allow the transaction's form to override its economic substance and specifies that the presumption can be overcome if interest is not stated, if the stated interest rate is unreasonable, or if the face amount of the note significantly differs from the current cash sales price of comparable items or from the note's fair value at the transaction date.

A7. When the "face amount of a note does not reasonably represent the present value of the consideration given or received in the exchange" Subtopic 835-30 provides alternatives for the initial measurement of the issued debt instrument.

> **835-30-25-2** If determinable, the established exchange price (which, presumably, is the same as the price for a cash sale) of property, goods, or service acquired or sold in consideration for a note may be used to establish the present value of the note. When notes are traded in an open market, the market rate of interest and quoted prices of the notes provide the evidence of the present value. These methods are preferable means of establishing the present value of the note.
>
> **835-30-25-10** In circumstances where interest is not stated, the stated amount is unreasonable, or the stated face amount of the note is materially different from the current cash sales price for the same or similar items or from the fair value of the note at the date of the transaction, the note, the sales price, and the cost of the property, goods, or service exchanged for the note shall be recorded at the fair value of the property, goods, or service or at an amount that reasonably approximates the fair value of the note, whichever is the more clearly determinable. That amount may or may not be the same as its face amount, and any resulting discount or premium shall be accounted for as an element of interest over the life of the note.

A8. If debt is measured by reference to the fair value of the goods or services received, there could be a difference between the issued debt's effective interest rate and contractual interest rate.[22]

[22] See also the guidance for imputing an interest rate in Subtopic 835-30.

Additional Background on Valuation of Debt Instruments in a Business Combination

A9. To provide additional background on how the fair value of debt instruments assumed in a business combination is determined in practice, the staff highlights the guidance included in the *AICPA Accounting and Valuation Guide: Business Combinations (2024)*.

> **Trade and Accounts Payable and Notes Payable**
>
> **13.182** Generally, settlement amount of trade accounts payable and notes payable approximates their fair value due to their short-term nature. With respect to long-term trade accounts payable and notes payable, given the lack of observable markets or observable inputs for the transfer of these liabilities, they are often measured using an income approach and discounted at the present value of the amounts to be paid, incorporating an appropriate discount rate reflective of nonperformance risk inherent in the amounts payable from a market participant view.
>
> **Considerations for Liabilities**
>
> **12.159** FASB ASC 820 states that an entity should consider its own risk of nonperformance when measuring the fair value of liabilities (for example, the entity's own credit rating). Generally, an entity will select a risk-free rate consistent with the remaining term of the liability arrangement, and adjust it based on a credit spread that is consistent with the entity's nonperformance risk. Further adjustments may be required if non-credit-related risks give rise to additional variability in the related cash flows. The task force recommends directly adjusting the cash flows to reflect all other risks. For example, a bond obligation based solely on contractual cash flows is often limited to nonperformance risk that would be captured in the developed rate of return. In contrast, when measuring a liability where cash flows are not contractual, there may be risk in addition to nonperformance risk due to uncertainty around the cash flows.

A10. The staff notes that these fair value estimates are sensitive to both the selected benchmark rate and the approach used in developing credit spread estimates. To provide further clarification on the methodology for estimating credit spreads—particularly for private companies—the staff has included excerpts from EY publication: *Financial Reporting Developments: Fair Value Measurement* outlining the process for evaluating a private company's creditworthiness.

> **D.10 Valuation Inputs**
>
> Regardless of methodology, PD [probability of default], LGD [loss given default] and/or credit spread assumptions are important inputs when determining a CVA [credit valuation adjustment]. While the sources of information may vary, the objective remains unchanged, that is, to incorporate inputs that reflect the assumptions of market participants in the current market.
>
> When available, current market-implied information should be used. For example, CDS [credit default swap] spreads may provide a good indication of the market's current perception of a particular reporting entity's or counterparty's creditworthiness. However, CDS spreads will likely not be available for smaller public companies or private entities. In these instances, reporting entities may need to consider other available indicators of creditworthiness, such as publicly traded debt or loans.
>
> In the absence of any direct indicator of creditworthiness, reporting entities may need to estimate credit spreads by comparison to industry peers or benchmarks (i.e., based on credit rating by region and/or sector). In either case, identifying the appropriate peer group or benchmark is critical. The basis for selecting the proxy or benchmark, including any analysis performed and assumptions made, should be documented. Such an

analysis may include calculating financial ratios to evaluate the reporting entity's financial position relative its peer group and their credit spreads. (These ratios may consider liquidity, leverage and/or other indicators of general financial strength.).

A11. Ultimately, changes in either (a) the risk-free rate or (b) indicators of the entity's creditworthiness occurring between original issuance of the debt instrument and the date of the fair value measurement can cause the discount rate used to determine fair value to differ from the contractual rate of interest.

Appendix B: Income Tax Accounting for Debt Issued with Warrants, Bifurcated Derivatives, and Debt Modifications

Detachable Warrants

B1. PwC publication, *Income Taxes* (June 2025) provides an overview of the financial reporting requirements for deferred taxes when a debt instrument is issued with detachable warrants. That publication notes that when debt is issued with other instruments like warrants, the allocation between the instruments for tax purposes may be different from the allocation used for financial reporting purposes, potentially resulting in temporary differences requiring deferred taxes.

Bifurcated Derivatives

B2. The PwC publication also provides an overview of financial reporting requirements for deferred taxes related to debt instruments with embedded derivatives. It explains that when an embedded conversion option is separated (bifurcated) from a convertible debt instrument, deferred taxes are typically recognized for both the debt host and the bifurcated derivative component. It notes that even if GAAP requires the separation of the derivative from the host contract, the debt host is often treated as a single instrument for tax purposes. As a result, deferred taxes are generally established for temporary differences associated with both the host contract (due to differences between GAAP carrying amount and tax basis) and the derivative (which would have a GAAP basis but no tax basis).

B3. The publication further describes that although these deferred tax balances will often offset at issuance, they may diverge over time because the derivative is remeasured at fair value each period, while any premium or discount on the host debt component is amortized.

B4. In situations in which there is no future tax effect associated with the settlement of the hybrid financial instrument, the PwC publication states that "we would not expect deferred taxes to be recognized."

Debt Modifications

B5. The PwC publication notes that, "generally, if a significant modification of the debt occurs, the existing debt is deemed to be exchanged for new debt for tax purposes" and that a gain or OID may be recognized for tax purposes upon a modification. This publication also highlighted that "the rules for debt modification for financial reporting and income tax reporting may not align. As such, deferred taxes may arise to the extent that there are differences."