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FASB Issues Final Standard on Induced Conversions of Convertible Debt Instruments

Overview

On November 26, 2024, the FASB issued ASU 2024-04,[1] which amends ASC 470-20[2] to clarify the requirements related to accounting for the settlement of a debt instrument as an induced conversion. Based primarily on the consensus-for-exposure reached on Issue 23-A[3] by the Emerging Issues Task Force on September 14, 2023, the ASU is intended to "improve the relevance and consistency in application of the induced conversion guidance in Subtopic 470-20 for (a) convertible debt instruments with cash conversion features and (b) debt instruments that are not currently convertible."

Background

Under current U.S. GAAP, entities use three primary accounting models to recognize settlements of convertible debt that are not accounted for as troubled debt restructurings:

- *Conversion accounting* — ASC 470-20, as amended by ASU 2020-06,[4] requires entities to apply this model to convertible debt instruments that have been settled in cash (or other assets) or shares, or a combination thereof, in accordance with their original contractual conversion terms. As a result, the carrying amount of a convertible debt

[1] FASB Accounting Standards Update (ASU) No. 2024-04, *Induced Conversions of Convertible Debt Instruments*.
[2] FASB Accounting Standards Codification (ASC) Subtopic 470-20, *Debt: Debt With Conversion and Other Options*.
[3] EITF Issue No. 23-A, "Induced Conversions of Convertible Debt Instruments."
[4] ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*.

instrument is transferred to equity upon conversion, without recognition of a gain or loss.[5]

- *Extinguishment accounting* — Entities apply this model to any convertible debt instruments settled with terms that differ (or are modified) from the original contractual conversion terms. Under this approach, entities calculate an extinguishment gain or loss equal to the difference between (1) the carrying amount of the convertible debt instrument and (2) the fair value of the consideration issued on settlement (which takes into account the value of the conversion feature).

- *Induced conversion accounting* — Entities apply this model when they have induced debt holders to promptly convert convertible debt into equity shares under changed conversion terms that are effective for a limited period and involve additional consideration. Under this approach, the issuer must recognize an inducement expense upon the conversion.

After adoption of ASU 2020-06,[6] stakeholders noted that it was difficult to determine whether to apply induced conversion accounting or extinguishment accounting to convertible debt instruments that are cash-settled in accordance with conversion terms that differ from the original contractual conversion terms.

Stakeholders also observed that it is unclear under existing GAAP whether induced conversion accounting applies to a convertible debt instrument whose conversion feature or features are not currently exercisable at the time of settlement.

Main Provisions

Among other updates, the ASU amends the guidance in ASC 470-20 to:

- Remove from the subsections on induced conversion references to (1) conversion into "equity" and (2) "equity securities," which clarifies that the guidance in these subsections could apply to conversions of convertible debt that settle in equity, cash (or other assets), or a combination thereof.

- Clarify that to qualify for induced conversion accounting, an inducement offer must preserve the issuance of all of the consideration (in form and amount) issuable in accordance with the conversion privileges specified in the terms of the existing debt instrument.

- Require that to qualify for induced conversion accounting, an instrument must contain a substantive conversion feature[7] as of the date on which both the issuance offer and the inducement offer are accepted by the convertible debt holder.

The ASU also provides examples that illustrate how to determine whether a settlement should be accounted for under the induced conversion guidance and, if so, how to apply the model to the facts in the examples.

Further, in applying the induced conversion model, an entity recognizes inducement expense on the basis of the difference between (1) the value of securities issued to settle the

[5] In accordance with ASC 470-20-40-4, as amended by ASU 2020-06, the conversion accounting model only applies to convertible debt instruments that are accounted for entirely as a liability (e.g., debt issued at a substantial premium would not be subject to this model if a portion of this debt was recorded to paid-in-capital).

[6] Before the adoption of ASU 2020-06, entities that settled convertible debt instruments with cash conversion features were required to (1) calculate an extinguishment gain or loss equal for the difference between the carrying amount of the liability component and the fair value of similar debt without a conversion feature and (2) recognize the settlement of the conversion feature in equity.

[7] The determination of whether a conversion feature is substantive is unchanged under the ASU (see ASC 470-20-40-7 through 40-10).

instrument and (2) the value of securities issued in accordance with the existing conversion privileges.[8]

Application of Induced Conversion Accounting

Under the ASU, ASC 470-20-40-13(a)–(c) provide the following three criteria that must be met for an entity to apply the induced conversion model to the settlement of a convertible debt instrument:

- The conversion must occur "pursuant to changed conversion privileges that are exercisable only for a limited period of time."
- The conversion must preserve "the consideration (in form and amount) issuable" before the inducement offer.
- The instrument must contain a "substantive conversion feature [at both] issuance and [on] the date the inducement offer is accepted" (even if the conversion feature is not exercisable at the time of the inducement offer).

ASU 2024-04 also provides guidance on determining whether the criterion in ASC 470-20-40-13(b) (second bullet above) is met. The ASU clarifies that an entity should compare (1) "the amount of cash (or other assets) and number of shares issuable" in connection with the existing conversion privileges at the time the inducement offer is made with (2) "the amount of cash (or other assets) and number of shares issuable" on the basis of the inducement offer.

Connecting the Dots

As long as the form and amount of consideration issued is at least equal to that issuable under existing terms, the criterion in ASC 470-20-40-13(b) would be met. For example, as illustrated in Case C in ASC 470-20-55-9A through 55-9D, the issuer may offer, as a "sweetener" to induce conversion, warrants that were not provided for in the instrument's existing terms; however, the warrants do not affect the assessment of whether the form and amount of consideration issuable under existing conversion privileges was preserved since the existing conversion terms did not include the issuance of warrants. In that example, the issuance of the warrants will, however, affect the measurement of the induced conversion expense.

Consider another example in which the existing conversion privileges of a convertible debt instrument provide for settlement of (1) the principal amount of the debt in cash and (2) the conversion spread in cash or common stock (commonly referred to as Instrument C). If the issuer provides an inducement offer to the holder to settle the convertible debt instrument entirely in shares, the induced conversion model would not apply since the conversion did not preserve the consideration in form and amount.

If conversion privileges (whether in the existing terms before settlement or in the inducement offer) are based on a future share price or average future share price (e.g., a volume-weighted average price), the comparison performed under ASC 470-20-40-13(b) would be based on the fair value as of the date the inducement offer is accepted (rather than the date on which it is settled).

In addition, if an entity modifies a convertible debt instrument multiple times within a one-year period, it must compare, in a manner consistent with the principles of ASC 470-50, the conversion privileges under the inducement offer with those that existed one year before the date of the offer (or, if outstanding for less than a year, whenever the instrument was issued).

[8] Unlike the proposed ASU, the final guidance uses the term "existing conversion privileges" (rather than "original conversion privileges") to acknowledge that a convertible debt instrument may have been modified in the period between its original issuance and the inducement offer.

Effective Date and Transition

Effective Date

The amendments in ASU 2024-04 are effective for annual reporting periods beginning after December 15, 2025 (and interim reporting periods within those annual reporting periods). Early adoption is permitted as of the beginning of a reporting period if the entity has also adopted ASU 2020-06 for that period.

Transition

Entities may apply the new guidance prospectively to settlements of convertible debt instruments that take place during annual reporting periods (and interim reporting periods within those annual reporting periods) beginning after the ASU's effective date. The nature of and reason for the change in accounting principle must be disclosed.

Retrospective application may be elected as of the beginning of the first comparative reporting period in which the entity has also applied ASU 2020-06. If such an election is made, transition disclosures must be provided in accordance with ASC 250.[9]

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[9] FASB Accounting Standards Codification Topic 250, *Accounting Changes and Error Corrections*.

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