

To the Point

FASB – proposed guidance

FASB proposes clarifying accounting for induced conversions of convertible debt instruments

The proposal would address how to apply the induced conversion accounting guidance to cash convertible debt instruments.

What you need to know

- ▶ The FASB proposed amendments that would clarify the requirements for determining whether to account for certain settlements of convertible debt instruments as induced conversions or extinguishments.
- ▶ The proposal would require an entity to account for a settlement as an induced conversion if the inducement offer includes the issuance of all of the consideration (in form and amount) issuable under the conversion privileges provided in the terms of the existing convertible debt instrument.
- ▶ Entities would be permitted to apply the guidance either prospectively to convertible debt instruments settled after the effective date or retrospectively, as of the beginning of the first comparative reporting period, to convertible debt instruments settled after the adoption of ASU 2020-06.
- ▶ Comments are due by 18 March 2024.

Overview

The Financial Accounting Standard Board (FASB or Board) proposed **amendments**¹ that would clarify the requirements for determining whether to account for certain early settlements of convertible debt instruments as induced conversions. The proposal would require that an induced conversion include the issuance of all the consideration (in form and amount) issuable under the conversion privileges provided in the terms of the existing instrument.

The proposal, which is based on a consensus-for-exposure of the Emerging Issues Task Force (EITF), is intended to address issues that stakeholders encountered when applying the guidance on induced conversions in Accounting Standards Codification (ASC) 470-20² to certain settlements of debt instruments with conversion options that may be settled entirely or partially in cash (i.e., cash convertible debt instruments).

The current induced conversion guidance applies to conversions that require the issuance of all equity securities issuable under the existing conversion terms, but it does not address situations in which equity securities are not issued upon conversion (e.g., cash convertible debt instruments).

Accounting Standards Update (ASU) 2020-06³ clarified that cash convertible debt instruments are subject to the same conversion guidance in ASC 470-20 as traditional convertible debt instruments, but it did not amend the induced conversion guidance. That left stakeholders questioning whether settlements of cash convertible debt instruments with changed conversion terms should be accounted for as induced conversions or extinguishments.

In an induced conversion, an issuer offers additional consideration beyond what is provided for in the existing conversion terms for a limited period of time. Issuers that meet all of the criteria to apply induced conversion accounting recognize an expense only for the fair value of the additional consideration transferred (known as a sweetener), and no gain or loss is recognized on the consideration issued under the conversion terms of the existing debt instrument.

An issuer that doesn't meet all of the criteria applies extinguishment accounting and recognizes a gain or loss for the difference between the fair value of the entire consideration transferred and the net carrying amount of the debt. As a result, there could be significant differences in the accounting for the settlement of a convertible debt instrument, depending on the type of accounting applied.

Key considerations

Preservation of the form and amount of consideration

Under the proposal, an entity would account for a settlement of a convertible debt instrument as an induced conversion if the inducement offer includes all the consideration (in form and amount) issuable under the conversion privileges provided in the terms of the existing convertible debt instrument. The issuer would assess whether this criterion is satisfied as of the inducement offer acceptance date.

The proposal would clarify when an entity would not apply induced conversion accounting to settlements of cash convertible debt instruments. For example, certain cash convertible debt instruments may require the issuer to settle the accreted value of the debt instrument in cash and the amount by which the as-converted value of the convertible debt exceeds the accreted value in cash, shares or any combination thereof, at the issuer's discretion (often referred to as Instrument C). If the issuer makes an inducement offer to settle the instrument fully in shares without offering cash for the accreted value, the settlement would not satisfy the criterion that the offer preserve the form of the consideration issuable under the instrument's existing conversion privileges. In this case, the entity would apply extinguishment accounting.

In addition, the proposal would require the issuer to assess whether the amount of cash and shares offered includes at least the amounts issuable under the instrument's existing conversion privileges. Cash convertible debt instruments often include conversion terms that use a volume-weighted average price (VWAP) formula over a specified future period to determine the settlement amount upon conversion. Changes in the price of the issuer's shares

during the period could affect the amount of cash or the number of shares to ultimately be issued upon conversion. These conversion terms may be modified in an inducement offer.

For example, the future period of time over which the VWAP formula is used may be shortened to three days from 30 days to facilitate a prompt conversion of the convertible debt instrument. In this case, it is possible that the holder could receive less consideration in the inducement offer than under the conversion privileges provided in the terms of the existing instrument, depending on the average of the future share prices.

The proposal would clarify that if the settlement terms under either the existing conversion privileges or the inducement offer are based on a future share price or average of future share prices (e.g., VWAP), an entity would use the fair value of the shares as of the offer acceptance date to determine the form and amount of consideration issuable. The issuer would not be required to apply extinguishment accounting because of a possibility that the holders could receive less cash or fewer shares than if they had converted under the existing conversion privileges of the instrument. That is, the incorporation, elimination or modification of a VWAP formula that is based on future share prices would not automatically preclude the application of induced conversion accounting.

The proposal includes several examples to illustrate the application of this guidance.

How we see it

If finalized, the proposed amendments would reduce diversity in practice in the application of the induced conversion guidance to certain settlements of cash convertible debt instruments.

One-year look-back

If there has been an exchange or a modification of the convertible debt that is not accounted for as a substantial modification (i.e., an extinguishment) under ASC 470-50⁴ in the one-year period preceding the offer acceptance date, the proposal would require an entity to use the terms of the convertible debt that existed a year before the offer is accepted for purposes of determining whether it can apply induced conversion accounting. The one-year look-back in the proposal would be similar to the look-back required under ASC 470-50 for applying the 10% cash flow test to determine whether a modification or exchange of a debt instrument should be accounted for as an extinguishment.

The proposed one-year look-back guidance would address the concern of some EITF members that, if there was no look-back, an issuer could modify the form of consideration shortly before settlement and apply induced conversion accounting rather than extinguishment accounting.

Debt instruments not currently convertible

The proposal would clarify that induced conversion accounting would apply to all convertible debt instruments that have a substantive conversion feature at the time of issuance and are in the scope of ASC 470-20, regardless of whether the instrument is currently convertible. ASC 470-20 defines a substantive conversion feature as “a conversion feature that is at least reasonably possible of being exercised in the future absent the issuer’s exercise of a call option.”

For example, a debt instrument that is contingently convertible upon an event that has not yet occurred (e.g., the instrument only becomes convertible upon an issuer’s exercise of a call option) would be in the scope of the guidance if the conversion feature is substantive at the time of issuance.

The incorporation, elimination or modification of a VWAP formula based on future share prices wouldn’t necessarily preclude induced conversion accounting.

Effective date and transition

Entities would have the option to apply the guidance either (1) prospectively to convertible debt instruments settled during the fiscal year beginning after the effective date or (2) retrospectively, as of the beginning of the first comparative reporting period, to convertible debt instruments settled after the adoption of ASU 2020-06.

The FASB will determine the effective date of the guidance and whether early adoption would be permitted after it considers stakeholder feedback on the proposal.

Endnotes:

- ¹ Proposed Accounting Standard Update, *Debt – Debt with Conversion and Other Options (Subtopic 470-20) – Induced Conversions of Convertible Debt Instruments (a consensus of the Emerging Issues Task Force)*.
- ² ASC 470-20, *Debt – Debt with Conversion and Other Options*.
- ³ ASU 2020-06, *Debt – Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging – Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*.
- ⁴ ASC 470-50, *Debt – Modifications and Extinguishments*.

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