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To the Point

FASB — final guidance

FASB clarifies accounting for induced conversions of convertible debt instruments

The guidance addresses how to apply the induced conversion accounting guidance to cash convertible debt instruments.

What you need to know

- The FASB issued final guidance that clarifies the requirements for determining whether to account for certain early settlements of convertible debt instruments as induced conversions or extinguishments.
- The guidance requires an entity to account for a settlement as an induced conversion if the inducement offer includes the issuance of all consideration (in form and amount) issuable under the conversion privileges provided in the terms of the existing convertible debt instrument.
- The guidance is effective for all entities for fiscal years beginning after 15 December 2025, and interim periods within those fiscal years. Early adoption is permitted for entities that have adopted ASU 2020-06.
- Entities can apply the guidance either prospectively to settlements of convertible debt instruments that occur after the effective date or retrospectively, as of the later of the beginning of the earliest period presented or the date the entity adopted ASU 2020-06.

Overview

The Financial Accounting Standards Board (FASB or Board) issued a final Accounting Standards Update (ASU)[1] that clarifies the requirements for determining whether to account for certain early settlements of convertible debt instruments as induced conversions. The guidance requires that an induced conversion include the issuance of all consideration (in form and amount) issuable under the conversion privileges provided in the terms of the existing instrument.

The guidance, 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) 470-20[2] to certain settlements of debt instruments with conversion options that may be settled entirely or partially in cash (i.e., cash convertible debt instruments).

Stakeholders had observed that the current induced conversion guidance in ASC 470-20-40-13(b) was issued before cash convertible debt instruments and debt instruments with other adjustment features became prevalent in the market. This guidance addresses induced conversion transactions that require the issuance of only equity securities under the existing conversion terms but does not address transactions that involve settlements of cash convertible debt instruments in which only a portion of or no equity securities may be issued upon conversion in accordance with the existing conversion terms of the instruments.

ASU 2020-06[3] clarified that cash convertible debt instruments are subject to the same conversion guidance in ASC 470-20 as debt instruments that are convertible only into equity securities but did not amend the induced conversion guidance. That left stakeholders questioning whether settlements of cash convertible debt instruments with changed conversion terms should be subject to the induced conversion guidance.

In an induced conversion, an entity offers additional consideration beyond what is provided for in the existing conversion terms for a limited period of time. Entities 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 entity 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

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

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 entity'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 during these periods.

The guidance clarifies that the incorporation, elimination or modification of a VWAP formula in an inducement offer does not automatically preclude the application of induced conversion accounting. That is, the entity will 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. Instead, an entity will use the fair value of the shares as of the offer acceptance date to determine whether the form and amount of consideration issuable under the terms of the existing instruments are preserved in the inducement offer.

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

How we see it

The ASU will 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 470-50[4] in the one-year period preceding the offer acceptance date, the guidance requires an entity to use the terms of the convertible debt that existed a year before the offer is accepted for purposes of determining whether the form and amount of consideration issuable under the existing conversion terms are preserved in the inducement offer. The one-year look-back is 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 one-year look-back does not affect how an expense would be measured.

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

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

Debt instruments not currently convertible

The guidance clarifies that induced conversion accounting can be applied to a convertible debt instrument that has a substantive conversion feature as of both its issuance date and the inducement offer acceptance date, 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 entity's exercise of a call option) is in the scope of the guidance if the conversion feature is substantive as of both the issuance date and the inducement offer acceptance date.

Effective date and transition

The guidance is effective for all entities for fiscal years beginning after 15 December 2025, and interim periods within those fiscal years.

Entities have the option to apply the guidance either (1) prospectively to settlements of convertible debt instruments that occur during fiscal years (and interim periods within those fiscal years) beginning after the effective date or (2) retrospectively. Under the retrospective transition approach, the entity recasts prior periods and recognizes a cumulative-effect adjustment to equity as of the later of the beginning of the earliest period presented or the date the entity adopted ASU 2020-06.

Early adoption is permitted for entities that have adopted ASU 2020-06 for both interim and annual financial statements that have not yet been issued or made available for issuance. An entity that adopts the guidance in an interim period is required to do so as of the beginning of the fiscal year that includes that interim period.

Endnotes:

[1] ASU 2024-04, *Debt — Debt with Conversion and Other Options (Subtopic 470-20) — Induced Conversions of Convertible Debt Instruments*.

[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*.