KPMG

FASB proposal

Induced conversions of convertible debt instruments

December 19, 2023

FASB issues a proposed Accounting Standards Update on induced conversion accounting for convertible debt instruments.

Applicability

- Proposed ASU, Induced Conversions of Convertible Debt Instruments
- Entities settling certain convertible debt instruments with cash conversion features (CCFs), referred to as Instrument C and Instrument X, pursuant to offers that differ from the instruments' existing terms.

Fast facts, impacts, actions

On September 14, 2023, the EITF reached a consensus-for-exposure on Issue 23-A, which would provide additional guidance on whether induced conversion or extinguishment accounting should be applied to certain settlements of convertible debt instruments that do not occur in accordance with the instruments' preexisting terms. The consensus-for-exposure was ratified by the Board on October 4, 2023 and was issued as a proposed Accounting Standards Update on December 19, 2023.

The proposed ASU would require companies to apply a preexisting contract approach. To qualify for induced conversion accounting under this approach, the inducement offer would need to preserve the form of consideration and result in an amount of consideration that is no less than that issuable pursuant to the preexisting conversion privileges.

The proposed ASU would clarify how companies should assess the form and amount of consideration when applying this approach. In addition, the proposed ASU would clarify that induced conversion accounting can be applied to settlements of certain convertible debt instruments that are not currently convertible.

Entities that have convertible debt with CCFs outstanding should consider how any in-process or anticipated settlement negotiations with holders may be affected. Entities should also consider the proposed transition policy elections if they had any settlements of convertible debt with CCFs after the adoption of ASU 2020-06 that would be subject to transition disclosures.

Other than transition disclosures, the proposed ASU does not contemplate any additional disclosure requirements specific to induced conversions.

The FASB seeks feedback from all stakeholders and comments are due by March 18, 2024.

Background

The issuance of ASU 2020-06 eliminated a separate accounting model for certain settlements of convertible debt instruments with CCFs. The elimination of that model amplified the difference in the impact to earnings when applying induced conversion versus extinguishment accounting. In addition, it is not always clear whether conversion accounting or extinguishment accounting is appropriate for certain settlements.

To illustrate the potential magnitude of the earnings difference between induced conversion versus extinguishment accounting, consider the following:

- ABC Corp has convertible debt outstanding with a $1,000 net carrying amount. The if-converted value of the debt is $1,500.
- ABC Corp settles the instrument in a transaction in which $100 of additional consideration is provided to the holder.

The following table summarizes the difference in earnings effect under the induced conversion accounting and extinguishment accounting models.

Accounting model	Earnings effect	ABC Corp. earnings example
Induced conversion accounting	• *Inducement charge* is equal to the excess of the fair value of securities / other consideration transferred over the fair value of shares issuable under the instrument's original terms.	• Inducement charge: $100 *(limited to the incremental consideration provided to induce settlement)* • On conversion, the carrying amount of the debt is reclassified to equity.
Extinguishment accounting	• *Extinguishment gain / loss* is equal to the entire excess of fair value of consideration transferred over the carrying amount of the instrument	• The liability is derecognized at the full fair value of the consideration transferred resulting in a loss on extinguishment of $600 *($1,600 transferred less $1,000 carrying amount)*

Preexisting contract approach

Under the proposed ASU, the preexisting contract approach would require that an entity (for both the original conversion privileges and the inducement offer) determine the amount of cash and the number of shares that would be issued based on the fair value of the entity's shares as of the offer acceptance date when assessing whether the induced conversion model can be applied. An entity would apply induced conversion accounting if the inducement offer provides, at a minimum, the cash and/or shares issuable under the preexisting conversion privileges.

Application of the preexisting contract approach would provide clarifying guidance for identifying induced conversions and promote consistency in accounting for settlements of certain convertible debt instruments. The introduction of the preexisting contract approach is expected to yield outcomes that are generally aligned with existing practice.

Clarification of certain criteria

The proposed ASU would clarify that the preexisting and modified conversion privileges are to be assessed as of the offer acceptance date. This aligns with the date on which the inducement expense is calculated.

The proposed ASU would also clarify that to evaluate whether the form and amount of consideration test for inducement accounting is satisfied when the convertible debt instruments have been exchanged or modified within the one-year period preceding the offer acceptance date (and the modification was not accounted for as an extinguishment), the entity would use the terms of the convertible debt instrument as they existed one year before the offer acceptance date.

Currently convertible instruments

The proposed ASU would clarify that a convertible debt instrument[1] that is in the scope of Subtopic 470-20 (because it contains a substantive conversion feature) would be subject to induced conversion accounting, assuming all other relevant criteria for induced conversion accounting are satisfied. As a result, even if an instrument is not currently convertible because of a contingency or because the conversion option is conditioned on the passage of time, it would be subject to the induced conversion accounting guidance. This is consistent with existing guidance for:

- conversion options that are out-of-the-money; and
- debt instruments that are contingently convertible but become immediately convertible upon the issuer's exercise of a call option.

Transition and transition disclosures

The proposed ASU would provide for required prospective application to convertible debt instruments settled after the effective date of the ASU. Retrospective application to instruments settled after the adoption of the amendments in ASU 2020-06 would be permitted, but not required.

Entities that elect to only apply the amendments prospectively would disclose the nature of and reason for the change in accounting principle.

Entities that elect to adopt the changes retrospectively would disclose the following in the period of adoption:

- the nature of the change in accounting principle, including an explanation of the newly adopted accounting principle;
- the method of applying the change;
- the cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the new requirements are initially applied; and
- the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for any prior periods retrospectively adjusted.

[1] A convertible debt instrument is an instrument that is accounted for as a liability in its entirety under Subtopic 470-20 when (a) it is not accounted for under the fair value option (under Topic 825), (b) the embedded conversion option does not need to be bifurcated as an embedded derivative, and (c) the instrument was not issued at a substantial premium.

Next steps

The FASB will determine the effective date and whether early application should be permitted after stakeholder feedback is considered.

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