FASB issues ASU

Induced conversions of convertible debt instruments

December 20, 2024

FASB issues Accounting Standards Update 2024-04 on induced conversion accounting for convertible debt instruments.

Applicability

- ASU 2024-04, Induced Conversions of Convertible Debt Instruments[1]
- 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 November 26, 2024, the FASB issued ASU 2024-04 on Induced Conversions of Convertible Debt Instruments. The ASU provides 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 ASU requires entities to apply a preexisting contract approach. To qualify for induced conversion accounting under this approach, the inducement offer is required 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.

ASU 2024-04 clarifies how entities should assess the form and amount of consideration when applying this approach. In addition, the new ASU clarifies that induced conversion accounting can be applied to settlements of certain convertible debt instruments that are not currently convertible as long as the instrument contained a substantive conversion feature as of both its issuance date and the inducement offer acceptance date.

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, ASU 2024-04 does not create any additional disclosure requirements specific to induced conversions.

1 A convertible debt instrument 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.

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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 was not always clear whether conversion accounting or extinguishment accounting was 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 ASU 2024-04, the preexisting contract approach requires that an entity (for both the original conversion privileges and the inducement offer) determines 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 applies 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 provides clarifying guidance for identifying induced conversions and promotes 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.

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Clarification of certain criteria

ASU 2024-04 clarifies 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 new ASU specifies that the incorporation, elimination or modification of a volume-weighted average price formula to which shares are indexed does not preclude induced conversion accounting from being applied.

The new ASU also clarifies 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 uses the terms of the convertible debt instrument as they existed one year before the offer acceptance date.

Currently convertible instruments

ASU 2024-04 clarifies that a convertible debt instrument that is in the scope of Subtopic 470-20 (because it contains a substantive conversion feature) is 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 is subject to the induced conversion accounting guidance as long as the instrument contained a substantive conversion feature as of both its issuance date and the inducement offer acceptance date. 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.

Effective dates and transition

	All Entities
Annual periods – Fiscal years beginning after	December 15, 2025
Interim periods – In fiscal years beginning after	December 15, 2025
Early adoption permitted?	Yes
Prospective application permitted?	Yes
Retrospective application permitted?	Yes – For entities that adopted the amendments in Update 2020-06.

Transition method	Application and disclosure requirements
Prospective	• Application – Applies to convertible debt instruments settled after the effective date of the ASU. • Disclosure requirements – Nature of the change in accounting principle. – Reason for the change in accounting principle.

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Transition method	Application and disclosure requirements
Retrospective	• Application – Applies to convertible debt instruments settled after the adoption of the amendments in ASU 2020-06. • Disclosure requirements – Nature of the change in accounting principle, including an explanation of the newly adopted accounting principle. – Method of applying the change. – 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. – 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.

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