BDO BULLETIN

INDUCED CONVERSIONS OF CONVERTIBLE DEBT INSTRUMENTS

NOVEMBER 2024

SUMMARY

The FASB recently clarified the requirements for determining whether a convertible debt settlement is accounted for as an induced conversion, rather than an extinguishment,[1] which determines the effect of the debt's settlement on net income. Induced conversion accounting applies to conversions that both (1) occur pursuant to conversion privileges that are exercisable only for a limited time and (2) include the issuance of all the equity securities issuable under the original conversion privileges. The Accounting Standards Update (ASU) provides guidance on how the second criterion is applied in specific situations, including a clarification that induced conversion accounting applies only if the inducement offer preserves the **form** and **amount** of consideration issuable under the instrument's existing conversion privileges. The ASU also added a third criterion, which requires the debt to contain a substantive conversion feature as of the issuance and offer acceptance date.

Entities may adopt the standard retrospectively for all prior periods presented in the financial statements or prospectively. The new guidance applies to fiscal years and interim periods within fiscal years beginning after December 15, 2025. Early adoption is allowed for entities that have adopted ASU 2020-06.[2]

BACKGROUND

A settlement of a convertible debt instrument is an induced conversion if it occurs based on conversion privileges that are changed to induce early conversion by the holder and are exercisable only for a limited time. Under that settlement, an entity recognizes an inducement expense computed as of the **offer acceptance date** as follows:

The fair value of all securities and other consideration transferred in the transaction (measured at the offer acceptance date)	−	The fair value of all securities and other consideration under the instrument's existing conversion privileges	=	Inducement Expense

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

[2] *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*

That outcome differs from an extinguishment gain or loss recognized upon a debt extinguishment. An induced conversion also differs from a conversion that occurs in accordance with the instrument's original conversion terms, in which no gain or loss is recognized upon conversion.

Previously, to be an induced conversion, the entity had to issue all the equity securities issuable under the debt's original conversion privileges. However, it was often not clear how that criterion applied to debt instruments with cash conversion features because those instruments do not require the entity to issue shares at conversion. Also, it was unclear how to apply that criterion when (1) the conversion privileges were changed to incorporate, eliminate, or modify a volume-weighted average price (VWAP) formula in the instrument's conversion terms and (2) whether the induced conversion guidance applies to convertible debt that is not currently convertible. The absence of guidance led to diversity in practice.

MAIN PROVISIONS

The ASU clarifies that:

- The induced conversion guidance can apply to a convertible debt instrument that is not currently convertible so long as it had a substantive conversion feature as of the issuance date and as of the date the inducement offer is accepted by the holder (the offer acceptance date).
- To qualify for induced conversion accounting, the inducement offer must preserve the consideration in form and amount. That means that the inducement offer must provide the holder with, at a minimum, consideration in the same form and amount, issuable under the conversion privileges provided in the terms of the existing debt instrument (the existing conversion privileges). The entity assesses this criterion as of the **offer acceptance date**.
    - To determine whether the inducement offer preserves the consideration in form and amount, an entity compares the amount of cash (or other assets) and the number of shares issuable under the existing conversion privileges with those under the inducement offer. For example, if the existing conversion privileges require settlement of the principal in cash and the conversion premium in any combination of cash and shares, but the inducement offer does not include cash consideration, the settlement does not qualify for induced conversion.
    - The ASU also clarifies how to assess this criterion in specific situations:

SCENARIO	ACCOUNTING CONSIDERATIONS
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 (such as VWAP)	Use the share price as of the **offer acceptance date** to compute the amount of cash payable and shares issuable under the existing conversion privileges. For example, if the existing conversion terms include a VWAP formula based on future share prices,[3] then incorporating, eliminating, or modifying that formula in the inducement offer[4] does not affect the determination of the amount of cash or number of shares issuable for the induced conversion assessment because the fair value of the shares on the offer acceptance date would be used instead of the future VWAP.
Changed terms cause the amount of cash (or other assets) or the number of shares to be indexed to something other than the future price of the issuer's shares (such as the fair value of a commodity)	Those changes are a change in the form of settlement, so induced conversion accounting does not apply.

[3] To illustrate, assume the convertible debt allows the entity to settle the principal and the conversion premium in any combination of cash and shares with a total value equal to a fixed number of shares times VWAP. Under the existing conversion privileges, the VWAP is computed using a 40-day period beginning the day after the holder notifies the entity that it will convert the debt.

[4] For example, the existing conversion terms require the total consideration to be computed using a 40-day VWAP while the inducement offer requires a 15-day VWAP.

SCENARIO	ACCOUNTING CONSIDERATIONS
The existing debt was exchanged or modified within one year before the offer acceptance date and was not an extinguishment under ASC 470-50, *Debt — Modifications and Extinguishments*	The conversion privileges that existed one year before the offer acceptance date are used in the induced conversion assessment, instead of the conversion privileges existing immediately before the inducement offer.

Two common types of cash convertible instruments are referred to as “Instrument C” and “Instrument X.” The table summarizes the induced conversion assessment for those instruments under the ASU assuming the conversion occurs based on changed conversion privileges that are exercisable for only a limited time.

DESCRIPTION	INDUCED CONVERSION ASSESSMENT
Instrument C: Requires the entity to settle the debt’s principal in cash and allows the entity to settle the conversion premium in cash or shares	▶ Induced conversion applies if the settlement under the inducement offer is fully in cash and the cash offered is sufficient to satisfy both the principal and the conversion premium under the existing conversion privileges. ▶ Induced conversion applies if the settlement under the inducement offer is for a combination of cash and shares and both of the following are met: • The cash offered is sufficient to satisfy the principal under the existing conversion privileges. • The amount offered (cash or shares) is sufficient to also satisfy the conversion premium (together with the principal) under the existing conversion privileges. ▶ Induced conversion does not apply (the transaction is accounted for as an extinguishment) if the settlement under the inducement offer is fully in shares because the form of the consideration under the existing conversion privileges would not be preserved by the offer.
Instrument X: Allows the entity to settle the if-converted value (principal plus conversion premium) in cash, shares, or any combination of cash and shares	▶ We believe induced conversion applies if the total amount offered (cash or shares) is sufficient to satisfy both the principal and conversion premium under the existing conversion privileges.

EFFECTIVE DATES AND TRANSITION

The following table summarizes the transition for the ASU:

	ALL ENTITIES
Effective Date	Fiscal years and interim periods within fiscal years beginning after December 15, 2025.
Early adoption	Allowed for entities that have adopted ASU 2020-06. If an entity adopts the ASU in an interim period, it must adopt the amendments as of the beginning of the annual period that includes that interim period.
Transition	Prospective to settlements of convertible debt instruments that occur on or after the date of adoption (including interim periods). Disclosure requirements include the nature of and reason for the change in accounting principle. Entities may elect to adopt the ASU retrospectively as of the beginning of the first reporting period in accordance with ASC 250-10-45-5 through 45-10. That method can be applied only to settlements of convertible debt that occur after adopting ASU 2020-06. Disclosure requirements include: ▶ The nature of and reason for the change in accounting principle ▶ The chosen method of adoption ▶ The cumulative effect on retained earnings or other components of equity as of the beginning of the first reporting period ▶ The effect on income from continuing operations, net income, and any other affected financial statement line item (including earnings per share, if presented)

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Link to the ASU

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APPENDIX

The following example illustrates how an entity evaluates whether an inducement offer preserves the form and amount of consideration issuable under the instrument's existing conversion privileges (the criterion in ASC 470-20-40-13(b)).

EXAMPLE (ADAPTED FROM ASC 470-20-55-9E THROUGH 55-9G): OFFER TO SETTLE CONVERTIBLE DEBT INSTRUMENT IN CASH AND SHARES

FACTS

On January 1, 2X24, Entity A issued $1,000 of 10% convertible debt at par (there is no original issue premium or discount) with the following terms:

- Matures on December 31, 2X33
- Convertible into Entity A's common shares at a conversion price of $25 per share.

The terms of the convertible debt require that, upon conversion, the entity settle the principal in cash and the conversion premium in any combination of cash and shares. Under the existing conversion privileges, the total value of the cash and shares required to be issued upon conversion equals 40 shares per convertible debt x the VWAP of Entity A's common stock. The VWAP is computed using a 40-day period beginning the day after the holder notifies Entity A that it will convert the debt.

On May 15, 2X27, to induce the debtholders to convert their debt promptly, Entity A offers the following consideration in exchange for each $1,000 convertible debt that is converted within 60 days:

- Cash payment of $1,400
- 10 shares of Entity A's common stock.

The offer is accepted by the debtholders on June 1, 2X27. The fair value of Entity A's common stock on that date is $40 per share.

CONCLUSION AND ANALYSIS

Assume the inducement offer is exercisable only for a limited time and the conversion feature is substantive at issuance and the offer acceptance date (in other words, the criteria in ASC 470-20-40-13(a) and 40-13(c) are met). To evaluate whether the inducement offer meets the criterion in ASC 470-20-40-13(b), Entity A compares the form and amount of consideration offered with the form and amount of consideration that would be issued under the existing conversion privileges. Under the existing conversion privileges, Entity A must settle the principal in cash and may settle the conversion premium in any combination of cash and shares.

- The inducement offer includes the form (cash) and amount ($1,000) of consideration that is sufficient to satisfy the principal under the existing conversion privileges.
- The conversion premium of $600 ((40 shares x $40) - $1,000) may be settled in any combination of cash and shares. The inducement offer includes the form (cash and shares) and amount ($400 cash and $400 (10 shares x $40)) worth of shares) sufficient to satisfy the conversion premium.

The fact that the inducement offer eliminates the VWAP formula contained in the existing conversion privileges and instead offers a specified amount of cash and shares does not affect whether the inducement offer includes the amount of consideration issuable under the existing conversion privileges because Entity A would use the fair value of its common stock as of the offer acceptance date to compute the amount of cash payable and shares issuable under the existing conversion privileges.

Therefore, the inducement offer meets the criterion in ASC 470-20-40-13(b).

Entity A computes the induced conversion expense as follows:

Total consideration under the inducement offer [a]	$	1,800
Less: value of shares issuable under the existing conversion privileges [b]		1,600
Induced conversion expense	$	200

[a] Total consideration under the inducement offer:

Cash	$	1,400
Fair value of shares (10 x $40)		400
Total consideration under the inducement offer	$	1,800

[b] Value of shares issuable under the existing conversion privileges:

Par amount	$	1,000
Divided by the original conversion price per share	$	25
Shares issuable pursuant to the existing conversion privileges		40
Multiplied by the fair value per common share on the offer acceptance date	$	40
Value of shares issuable under the existing conversion privileges	$	1,600

Because the settlement qualifies for induced conversion accounting, Entity A recognizes an inducement expense of $200, which differs from an extinguishment loss of $800 ($1,800 - $1,000) that Entity A would have recognized if the settlement were accounted for as an extinguishment, assuming the convertible debt's carrying amount was $1,000.