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New FASB Guidance on Induced Conversions

On November 26, 2024, FASB issued Accounting Standards Update (ASU) 2024-04, which clarifies several issues related to convertible debt securities, including:

- **When the requirements for induced conversion accounting apply**
- **How to apply the induced conversion guidance to convertible debt instruments that do not require the issuance of equity securities**
- **When induced conversion guidance can be applied to a convertible debt instrument that is not currently convertible**

All Entities Effective Date ASU 2024-04	Annual reporting periods beginning after December 15, 2025 (including interim periods)

Background

An induced conversion of convertible debt is when a company offers sweeteners (additional shares or other considerations) to entice investors to convert an instrument. When an instrument's terms are temporarily changed to induce conversion, current GAAP provides guidance for determining if the transaction should be accounted for as an induced conversion or a debt extinguishment rather than a typical conversion. For an induced conversion, an entity recognizes an expense only for the consideration in excess of what was issuable under the original conversion terms. For an extinguishment, an entity recognizes a gain or loss for the difference between the reacquisition price and the net carrying amount of the extinguished instrument.

Convertible debt instrument features and accounting have evolved significantly since FASB's predecessor—the Accounting Principles Board (APB)—issued ABP Opinion 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, in 1969. In 2020, FASB issued ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*, which made targeted changes to simplify the guidance on convertible instruments and reduced the number of accounting models for separate accounting of conversion options in convertible debt to two, including eliminating the cash conversion model established in 2008 in FASB Staff Position APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*. The removal of the settlement guidance for cash convertible debt, in turn, had unforeseen consequences on the accounting model for induced conversions, which had initially been established by FASB in Statement of Financial Accounting Standards (SFAS) No. 84, *Induced Conversions of Convertible Debt*, in 1985 and amended over time. This ASU provides the clarity requested by FASB's constituents necessitated as the literature has evolved.

Selected Convertible Debt Accounting Guidance Timeline

1969	1985	2008	2020	2024
ABP 14	SFAS 84	APB14-1	ASU 2020-06	ASU 2024-04

Resource: Accounting for Convertible Instruments

Qualification as an Induced Conversion

One current qualification for induced conversion accounting is that the settlement results in the holder receiving "all of the equity securities" issuable under the conversion terms at debt issuance. With the elimination of the cash conversion models, determining how to apply "all of the equity securities" criteria was not clear for a convertible debt instrument with a cash conversion feature, where there may be settlement alternatives that capture the economics of a conversion feature but do not require the actual issuance of shares.

Under ASU 2024-04, to account for a settlement of a convertible debt instrument as an induced conversion, an inducement offer must provide the debt holder with—**at a minimum**—the consideration (in form[1] and amount) issuable under the conversion privileges under the terms of the existing debt instrument. This assessment would be made as of the offer acceptance date.

For example, assume that with an original contractual conversion, the investor would have received $1,000 in cash and any incremental value in cash or shares. Further, assume that on the offer acceptance date, the original contractual incremental value would have been $200. Now, with the offer, assume they would receive $1,000 in cash and $400 in shares. The investor would receive consideration in the form and amount to qualify as an inducement as the cash was consistent ("at a minimum") with the original terms and the excess amount settled using **any** combination of cash or shares. However, if that same $1,400 in value were to be delivered in the offer in cash of $800 and shares of $600, it would not be an inducement because, in form, only $800 was received in cash, less than the original contractual amount of $1,000.

If the convertible debt instrument had been modified (without being deemed extinguished as being substantially different) within a one-year period before the offer acceptance date, then an entity would compare the terms in the inducement offer with the terms that existed one year before the offer acceptance date to reduce the likelihood of a structured result on settlement through multiple changes in terms.

ASU 2024-04 does not change the other existing criteria that must be satisfied to account for a settlement transaction as an induced conversion, *e.g.*, changed conversion terms must be for a limited time frame.

Volume-Weighted Average Price (VWAP) Formulas

VWAP formulas in convertible debt instruments are used to ensure that the settlement is based on the average price of the underlying shares over a specified trading period to avoid the potential to settle based on a share price from a volatile day.

ASU 2024-04 addresses the incorporation, elimination, or modification of a VWAP formula by requiring the issuer to assess whether the form and amount of conversion consideration are preserved (the "at a minimum" concept above) using the fair value of an entity's shares as of the offer acceptance date in lieu of a VWAP that is calculated

[1] Changes that result in the amount of cash (or other assets) and number of shares being indexed to something other than the future price of the issuer's shares, *e.g.*, the fair value of a commodity, would be considered a change in the form of settlement.

over a future period. A failure to preserve the form and amount of consideration issuable under the original conversion privileges would result in extinguishment accounting.

"For example, the incorporation, elimination, or modification of a VWAP formula that is based on future share prices 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 as of the date the inducement offer is accepted would be used instead of the future VWAP. A future share price refers to a share price measured after the inducement offer is accepted." – FASB, ASU 2024-04.

Instruments Not Currently Convertible

Based on the current codification and changes in ASU 2020-06, it was not clear how or when the induced conversion model would be applied to instruments that were not currently convertible or could become convertible on the occurrence of a future contingent event.

ASU 2024-04 clarifies that the induced conversion guidance applies to a convertible debt instrument that is not currently convertible if it has a **substantive conversion feature** as of both its issuance date and the offer acceptance date. A substantive conversion feature is already defined broadly in GAAP as a conversion feature that is at least reasonably possible to be exercisable in the future absent the issuer's exercise of a call option, with additional guidance that is applied in making that determination.

Transition & Effective Date

The changes will be effective for all entities for annual reporting periods beginning after December 15, 2025, and interim reporting periods within those annual reporting periods. Early adoption is permitted for all entities that have adopted ASU 2020-06. The changes can be applied on a prospective or retrospective basis.

Under a prospective approach, an entity would apply the amendments to any settlements of convertible debt instruments that occur after the adoption date. Under a retrospective approach, an entity would recast prior periods and recognize a cumulative-effect adjustment to equity as of the later of the following dates:

- The beginning of the earliest period presented
- The date the entity adopted ASU 2020-06

An entity cannot apply ASU 2024-04 retrospectively to settlements that occurred before the adoption date of ASU 2020-06, even if ASU 2020-06 was applied retroactively.

Transition disclosures include:

- For prospective adoption, the nature of and reason for the change in accounting principle in the financial statements of both the interim reporting period (if applicable) and the annual reporting period of the change
- For retrospective adoption, in the financial statements of both the interim reporting period (if applicable) and the annual reporting period of the change:

- 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 initially applied
- 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

Conclusion

The assurance team at Forvis Mazars delivers extensive experience and skilled professionals to assist with your objectives. Our proactive approach includes candid and open communication to help address your financial reporting needs. At the end of the day, we know how important it is for you to be able to trust the numbers; our commitment to independence and objectivity helps provide the security and confidence you desire. Whether you are publicly traded or privately held, Forvis Mazars can help provide an independent and objective view into your financial reporting. We leverage some of the latest technologies and process automation tools to provide companies assurance on their financial statements to help meet stakeholders' needs.

For more information, please reach out to a professional at Forvis Mazars.

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