Snapshot

DECEMBER 10, 2024
SNAPSHOT 2024-07

Induced conversion of convertible debt

The FASB recently issued ASU 2024-04, *Debt – Debt with Conversion and Other Options (Subtopic 470-20): Induced Conversions of Convertible Debt Instruments,* to clarify whether the settlement of convertible debt, including debt containing cash conversion features at terms that are different from the terms included in the existing debt instrument, should be accounted for as an induced conversion or a debt extinguishment.

If the settlement is an induced conversion, an entity recognizes an inducement expense measured as of the offer acceptance date, equal to the fair value of all securities and other consideration transferred in excess of the fair value of the securities and other consideration issuable pursuant to the conversion terms of the existing instrument.

If the settlement is an extinguishment, an entity recognizes an extinguishment gain or loss measured as of the extinguishment date, equal to the difference between the amount of total consideration transferred and the net carrying amount of the convertible debt.

Prior to the issuance of ASU 2024-04, the guidance on induced conversions included a criterion requiring that an induced conversion should include the issuance of *all equity securities* issuable in accordance with the conversion terms of the debt that existed at its issuance.

Prior to the issuance of ASU 2024-04, the U.S. GAAP guidance did not address:

- How this criterion should be applied to the settlement of a convertible debt instrument that does not require issuance of equity securities upon conversion (for example, a convertible debt instrument with a cash conversion feature);
- How the incorporation, elimination, or modification of a volume-weighted average price (VWAP) formula interacts with this criterion; and
- Whether the guidance on induced conversions may be applied to the settlement of a convertible debt instrument that is not currently convertible.

Induced conversions

The amendments in ASU 2024-04 require all the following criteria to be met for a settlement to qualify as an induced conversion:

- The settlement should occur under revised conversion terms that can be exercised only for a limited period of time.

- The settlement should result in the issuance of all of the consideration (in form and amount) issuable pursuant to the conversion terms of the existing convertible debt instrument.

- The settlement should involve a convertible debt instrument, regardless of whether it is currently convertible, that contains a substantive conversion feature as of both the date when initially issued and the date when the inducement offer is accepted by the convertible debt holder.

Issuance of all of the consideration (in form and amount)

Under the amendments in ASU 2024-04, the inducement offer should result in the issuance of all of the consideration, in form and amount, that is issuable under the existing convertible debt. This assessment should occur as of the date when the offer is accepted. The amendments also clarify the following:

- If the conversion terms under either the existing convertible debt or the inducement offer are based on a future share price (that is, the share price measured after the offer has been accepted) or on an average of future share prices (such as a VWAP), then the fair value of the shares as of the date when the inducement offer is accepted should be used to calculate the amount of cash (or other assets) as well as the number of shares issuable under the existing convertible debt and the inducement offer.

- Any change that causes the amount of cash (or other assets) and number of shares issuable not to be indexed to the future price of the issuer's shares (for example, a change in the fair value of a commodity) is considered a change in the form of consideration that is not eligible for induced conversion accounting.

- If the convertible debt is exchanged or modified within the one-year period prior to the date when the inducement offer is accepted by the convertible debt holder and was not considered extinguished under ASC 470-50 at that time, then the conversion terms of the existing debt instrument that existed one year before the date when the offer is accepted by the convertible debt holder will be used to determine the applicability of inducement accounting.

Refer to Appendix A to see how to apply this guidance to common convertible debt instruments.

Existence of substantive conversion feature

The guidance in ASU 2024-04 clarifies that in order to be eligible for inducement accounting, a convertible debt should have a substantive conversion feature both when initially issued and when the inducement offer is accepted by the debt holder. Convertible debt that is not currently convertible based on its existing terms when the issuer makes an inducement offer is eligible for induced conversion accounting, provided that (1) the conversion option is substantive as of both the debt issuance date and the offer acceptance date, and (2) the other induced conversion criteria are met.

Transition and effective date

The guidance in ASU 2024-04 is effective for all entities for annual reporting periods beginning after December 15, 2025 and for interim reporting periods within those annual reporting periods. If the guidance is adopted in an interim reporting period, it should be applied as of the beginning of the annual reporting period that includes that interim reporting period.

Early adoption is permitted in an interim or annual reporting period if the financial statements have not yet been issued (or been made available for issuance), but not earlier than the adoption of the amendments in 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*.

The amendments in ASU 2024-04 can be adopted either on a prospective or on a retrospective basis.

Under the prospective transition approach, an entity would apply the amendments to any settlement of convertible debt instruments occurring after the adoption date.

Under the retrospective transition approach, an entity would apply the amendments to any settlement of a convertible debt instrument that occurs after the entity adopts the amendments in ASU 2020-06 and would recast prior periods and cumulative-effect adjustment to equity as of the beginning of the earliest period presented.

The following transition disclosure requirements apply in both the interim reporting period and the annual reporting period when the amendments in ASU 2024-04 are adopted:

- Under the prospective transition approach, the nature of, and reason for, the change in accounting principle
- Under the retrospective transition approach:
  - The nature of the change in accounting principle and an explanation of the newly adopted 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, any other affected financial statement line item, and any affected per share amounts (if presented) of any prior periods retrospectively adjusted

Appendix A: Applying the 'all consideration (in form and amount)' guidance by type of convertible debt instrument

Convertible instrument	Induced conversion	Extinguishment
Traditional convertible debt — Upon conversion, the issuer must satisfy the obligation by issuing a fixed number of shares.	Issuance of at least all shares required under the existing debt agreement	Issuance of shares less than the number of shares required to be issued in accordance with the existing debt agreement, with the shortfall paid in cash
Instrument A — Upon conversion, the issuer must satisfy the obligation entirely in cash based on the conversion value.	Payment of at least the amount of cash required under the existing debt agreement to settle the conversion value	Payment of cash less than the amount required under the existing debt agreement, with the shortfall settled in shares
Instrument B — Upon conversion, the issuer may satisfy the entire obligation in either stock or cash in an amount equal to the conversion value	If the issuer chooses to settle in cash, then payment of at least the amount of cash required to settle the conversion value, or if the issuer chooses to settle in shares, then issuance of at least the number of shares required to settle the conversion value	Payment of combination of shares and cash in an amount equal to conversion value
Instrument C — Upon conversion, the issuer must satisfy the accreted value of the obligation (the accrued amount excluding the conversion spread) in cash and may satisfy the conversion spread (the excess of the conversion value over the accreted value) in either cash or stock.	If the issuer chooses to settle in cash, then payment of at least the amount of cash to settle the accreted value and conversion amount If the issuer chooses to settle in both cash and shares, then payment of at least the amount of cash to settle the accreted value	Settlement that does not include at least the amount of cash to settle the accreted value
Instrument X — Upon conversion, the issuer may satisfy the obligation in shares, cash, or any combination of shares and cash.	The settlement amount (either cash or shares or a combination of cash and shares) at least equals the conversion value	The settlement amount (either cash or shares or a combination of cash and shares) does not equal the conversion value

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