

Proposed Accounting Standards Update

Issued: December 19, 2023
Comments Due: March 18, 2024

Debt—Debt with Conversion and Other
Options (Subtopic 470-20)

Induced Conversions of Convertible Debt Instruments

a consensus of the Emerging Issues Task Force

The Board issued this Exposure Draft to solicit public comment on proposed changes to Subtopic 470-20 of the *FASB Accounting Standards Codification*[®]. Individuals can submit comments in one of three ways: using the electronic feedback form on the FASB website, emailing comments to director@fasb.org, or sending a letter to “Technical Director, File Reference No. 2023-ED600, FASB, 801 Main Avenue, PO Box 5116, Norwalk, CT 06856-5116.”

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft until March 18, 2024. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at [Exposure Documents Open for Comment](#)
- Emailing comments to director@fasb.org, File Reference No. 2023-ED600
- Sending a letter to “Technical Director, File Reference No. 2023-ED600, FASB, 801 Main Avenue, PO Box 5116, Norwalk, CT 06856-5116.”

All comments received are part of the FASB’s public file and are available at www.fasb.org.

The *FASB Accounting Standards Codification*[®] is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective. A copy of this Exposure Draft is available at www.fasb.org.

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

The Board is issuing this proposed Update to improve the application and relevance of the induced conversion guidance in Subtopic 470-20, *Debt—Debt with Conversion and Other Options*.

When the terms of a convertible debt instrument are changed to induce conversion of the instrument, current generally accepted accounting principles (GAAP) provide guidance for determining whether the transaction should be accounted for as an induced conversion (as opposed to a debt extinguishment). The induced conversion guidance was written in the context of share-settled convertible debt before cash convertible instruments became prevalent in the marketplace. That fact, as well as amendments to the accounting for convertible debt instruments with cash conversion features made by Accounting Standards Update No. 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*, has resulted in questions from stakeholders about how to determine whether a settlement of convertible debt (particularly cash convertible instruments) at terms that differ from the original conversion terms should be accounted for under the induced conversion or extinguishment guidance.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update would affect entities that settle convertible debt instruments for which the conversion privileges were changed to induce conversion.

What Are the Main Provisions, How Would the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP), and Why Would They Be an Improvement?

Under current GAAP, the guidance on induced conversions applies only to conversions that include the issuance of all equity securities issuable pursuant to the conversion privileges provided in the terms of the debt at issuance. Current GAAP does not address how this criterion should be applied to the settlement of a convertible debt instrument that does not require the issuance of equity securities upon conversion (for example, a convertible debt instrument with a cash conversion feature). Current GAAP also does not address how the incorporation, elimination, or modification of a volume-weighted average price (VWAP) formula interacts with this criterion, including when such changes could result in the holder receiving less cash or fewer shares than if the debt instrument had been settled in accordance with the conversion privileges provided in the terms of the instrument (prior to any changes to induce conversion). Stakeholders also have noted that, under current GAAP, it is not clear whether the guidance on induced conversions can be applied to the settlement of a convertible debt instrument that is not currently convertible.

The amendments in this proposed Update would clarify the requirements for determining whether certain settlements of convertible debt instruments should be accounted for as an induced conversion. Under the proposed amendments, to account for a settlement of a convertible debt instrument as an induced conversion, an inducement offer would be required to provide the debt holder with, at a minimum, the consideration (in form and amount) issuable under the conversion privileges provided in the terms of the instrument. An entity would assess whether this criterion is satisfied as of the date the inducement offer is accepted by the holder. If, when applying this criterion, the convertible debt instrument had been modified (without being deemed substantially different) within the one-year period leading up to the offer acceptance date, then an entity would compare the terms provided in the inducement offer with the terms that existed one year before the offer acceptance date. The proposed amendments would not change the other existing criteria that are required to be satisfied to account for a settlement transaction as an induced conversion.

The amendments in this proposed Update also would make additional clarifications to assist stakeholders in applying the proposed guidance. Under the proposed amendments, the incorporation, elimination, or modification of a VWAP formula would not automatically cause a settlement to be accounted for as an extinguishment; an entity would instead assess whether the form and amount of conversion consideration are *preserved* (that is, provided for in the inducement offer) using the fair value of an entity's shares as of the offer acceptance date.

The amendments in this proposed Update also would clarify that the induced conversion guidance can be applied to a convertible debt instrument that is not currently convertible so long as it had a substantive conversion feature as of its issuance date and is within scope of the guidance in Subtopic 470-20.

What Are the Transition Requirements and When Would the Amendments Be Effective?

The amendments in this proposed Update would permit an entity to apply the new guidance on either a prospective or a retrospective basis.

Under the prospective transition approach, an entity would apply the amendments in this proposed Update to any settlements of convertible debt instruments that occur after the effective date of the guidance.

Under the retrospective transition approach, an entity would recast prior periods and recognize a cumulative-effect adjustment to equity as of the later of the following dates: (1) the beginning of the earliest period presented and (2) the date the entity adopted the amendments in Update 2020-06. That is, an entity would not be permitted to apply the amendments in this proposed Update retrospectively to settlements that occurred prior to the adoption of the amendments in Update 2020-06 (including settlements occurring within periods that were recast retrospectively under the full retrospective transition approach permitted by Update 2020-06).

The effective date and whether early application should be permitted will be determined after stakeholder feedback on this proposed Update has been considered.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Induced Conversion Assessment

Question 1: Do you agree with the proposed amendments to the induced conversion criterion in paragraph 470-20-40-13(b) that would require that an inducement offer preserve the consideration (in form and amount) issuable pursuant to conversion privileges provided in the terms of the debt instrument? Please explain why or why not.

Question 2: Do you agree that the proposed induced conversion criterion in paragraph 470-20-40-13(b) should be assessed as of the date the inducement offer is accepted by the convertible debt holder? Please explain why or why not.

Question 3: Do you agree with the proposed amendments in paragraph 470-20-40-13A(c) that, if the debt has been exchanged or modified (without being deemed to be substantially different) within the one-year period preceding the offer acceptance date, then the conversion privileges provided in the debt terms that existed one year before the offer acceptance date (rather than the conversion privileges provided in the terms of the debt instrument) should be used for the induced conversion assessment? If not, please explain why and state which alternative approach you would support (see paragraph BC52 for other approaches considered by the Task Force, including a principle-based approach).

Question 4: Do you agree that all convertible debt instruments, including convertible debt instruments that are not currently convertible, should be eligible for induced conversion accounting if they contained a substantive conversion feature at issuance and the other criteria in paragraph 470-20-40-13 are met? Please explain why or why not.

Question 5: Would the proposed amendments provide decision-useful information? Are the proposed amendments clear and operable? Please explain why or why not.

Transition and Effective Date

Question 6: The proposed transition requirements would allow entities to apply the proposed amendments on either a prospective or a retrospective basis. Would the information required to be disclosed under the proposed transition method be decision useful? Please explain why or why not. Are the proposed transition requirements operable? If not, why not and what transition method would be more appropriate and why?

Question 7: In evaluating the effective date, how much time would be needed to implement the proposed amendments? Should the effective date for entities other than public business entities be different from the effective date for public business entities? Should early adoption be permitted? Please explain why or why not.

Amendments to the *FASB Accounting Standards Codification*[®]

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2 and 3. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Subtopic 470-20

2. Amend paragraphs 470-20-05-10, 470-20-40-13 through 40-17, 470-20-55-1B, 470-20-55-4 through 55-5 and the related heading preceding paragraph 470-20-55-3, and 470-20-55-7 through 55-8 and the related heading preceding paragraph 470-10-55-6, and add paragraphs 470-20-40-13A, 470-20-55-1C, 470-20-55-9A through 55-9J and the related headings, and 470-20-65-4 and its related heading, with a link to transition paragraph 470-20-65-4 as follows:

Debt—Debt with Conversion and Other Options

Overview and Background

> Induced Conversions

470-20-05-10 Some convertible debt instruments include provisions allowing the debtor to alter terms of the debt to the benefit of debt holders. In some circumstances, conversion privileges for a convertible debt instrument are changed or additional consideration is paid to debt holders for the purpose of inducing prompt conversion of the debt instrument ~~to equity securities~~ (sometimes referred to as a convertible debt sweetener). Such provisions may be general in nature, permitting the debtor or trustee to take actions to protect the interests of the debt holders, or they may be specific, for example, specifically authorizing the debtor to temporarily reduce the conversion price for the purpose of inducing conversion.

Derecognition

> Contractual Conversion

470-20-40-4 If a convertible debt instrument accounted for in its entirety as a liability under paragraph 470-20-25-12 is converted into shares, cash (or other assets), or any combination of shares and cash (or other assets), in accordance with the conversion privileges provided in the terms of the instrument, upon conversion the carrying amount of the convertible debt instrument, including any unamortized premium, discount, or issuance costs, shall be reduced by, if any, the cash (or other assets) transferred and then shall be recognized in the capital accounts to reflect the shares issued and no gain or loss is recognized.

> Conversion upon Issuer's Exercise of Call Option

470-20-40-5 The following guidance addresses accounting for the issuance of equity securities to settle a debt instrument (pursuant to the instrument's original conversion terms) that became convertible upon the issuer's exercise of a call option:

- a. **Substantive conversion feature.** If the debt instrument contained a substantive conversion feature as of **time of issuance**, the issuance of equity securities shall be accounted for as a contractual conversion. That is, no gain or loss shall be recognized related to the equity securities issued to settle the instrument.
- b. **No substantive conversion feature.** If the debt instrument did not contain a substantive conversion feature as of time of issuance, the issuance of equity securities shall be accounted for as a debt extinguishment. That is, the **fair value** of the equity securities issued should be considered a component of the reacquisition price of the debt.

470-20-40-6 The assessment of whether the conversion feature is substantive may be performed after time of issuance but shall be based only on assumptions, considerations, and marketplace information available as of time of issuance.

• > **Determining Whether a Conversion Feature Is Substantive**

470-20-40-7 By definition, a substantive conversion feature is at least **reasonably possible** of being exercised in the future. If the conversion price of an instrument at issuance is extremely high so that conversion of the instrument is not deemed at least reasonably possible as of time of issuance, then the conversion feature would not be considered substantive.

470-20-40-8 For purposes of determining whether a conversion feature is reasonably possible of being exercised, the assessment of the holder's intent is not necessary. Therefore, even if such an instrument included a conversion feature that provided for conversion due solely to the passage of time (for example, the instrument will become convertible at a date before its maturity date), it would be inappropriate to conclude that the conversion feature is substantive. Also, an instrument that became convertible only upon the issuer's exercise of its call option does not possess a substantive conversion feature.

470-20-40-9 Methods that may be helpful in assessing whether a conversion feature is substantive include the following:

- a. The fair value of the conversion feature relative to the fair value of the debt instrument. Comparing the fair value of a conversion feature to the fair value of the debt instrument (that is, the complete instrument as issued) may provide evidence that the conversion feature is substantive.
- b. The effective annual interest rate per the terms of the debt instrument relative to the estimated effective annual rate of a nonconvertible debt instrument with an equivalent expected term and credit risk. Comparing the effective annual interest rate of the debt instrument to the effective annual rate the issuer estimates it could obtain on a similar nonconvertible instrument may provide evidence that a conversion feature is substantive.
- c. The fair value of the debt instrument relative to an instrument that is identical except for which the conversion option is not contingent. Comparing the fair value of the debt instrument to the fair value of an identical instrument for which conversion is not contingent isolates the effect of the contingencies and may provide evidence about the substance of a conversion feature. If the fair value of the debt instrument is similar to the fair value of an identical convertible debt instrument for which conversion is not contingent, then it may indicate that the conversion feature is substantive. However, this approach may not be

appropriate unless it is clear that the conversion feature, not considering the contingencies, is substantive.

- d. Qualitative evaluation of the conversion provisions. The nature of the conditions under which the instrument may become convertible may provide evidence that the conversion feature is substantive. For example, if an instrument may become convertible upon the occurrence of a specified contingent event, the likelihood that the contingent event will occur before the instrument's maturity date may indicate that the conversion feature is substantive. However, this approach may not be appropriate unless it is clear that the conversion feature, not considering the contingencies, is substantive.

470-20-40-10 The guidance in paragraphs 470-20-40-7 through 40-9 does not address the treatment of an instrument for purposes of applying Subtopic 260-10.

> Induced Conversions

470-20-40-13 The guidance in paragraph 470-20-40-16 applies to conversions of convertible debt instruments to equity securities pursuant to terms that reflect changes made by the issuer debtor to the conversion privileges provided in the terms of the existing debt instrument at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. That guidance applies only to conversions for which all of the following criteria are satisfied that both:

- a. The conversion occurs ~~Occur~~ pursuant to changed conversion privileges that are exercisable only for a limited period of time (inducements offered without a restrictive time limit on their exercisability are not, by their structure, changes made to induce prompt ~~conversion~~ conversion).
- b. The conversion includes ~~include~~ the issuance of all of the consideration (in form and amount) ~~equity securities~~ issuable pursuant to conversion privileges provided in the terms of the existing debt instrument ~~included in the terms of the debt at issuance~~ for each debt instrument that is converted, regardless of the party that initiates the offer or whether the offer relates to all debt holders. See paragraph 470-20-40-13A for additional guidance applicable to debt instruments whose conversion privileges permit the entity to issue cash (or other assets) or a combination of shares and cash (or other assets) upon conversion. The

examples in paragraphs 470-20-55-9A through 55-9J illustrate the application of this guidance.

- c. The existing debt instrument, regardless of whether it is currently convertible, contained a substantive conversion feature as of time of issuance. See paragraphs 470-20-40-6 through 40-10 for guidance on determining whether a conversion feature is substantive as of time of issuance.

470-20-40-13A In applying the guidance in paragraph 470-20-40-13(b), an entity shall compare the amount of cash (or other assets) and number of shares issuable under the conversion privileges provided in the terms of the existing instrument with the amount of cash (or other assets) and number of shares issuable under the inducement offer. An entity shall consider the following:

- a. For purposes of comparing the amount of cash (or other assets) and number of shares issuable, if the 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 a volume-weighted average price), then an entity shall use the fair value of the shares as of the date the inducement offer is accepted. For example, the incorporation, elimination, or modification of a volume-weighted average price 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 volume-weighted average price. A future share price refers to a share price measured after the inducement offer is accepted.
- b. 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 (for example, the fair value of a commodity) shall be considered a change in the form of settlement.
- c. If within the one-year period preceding the date the inducement offer is accepted by the convertible debt holder the existing debt has been exchanged or modified (without being deemed to be substantially different in accordance with the guidance in Subtopic 470-50), then the conversion privileges provided in the debt terms that existed one year before the date the offer is accepted by the convertible debt holder shall

be used in place of the conversion privileges provided in the terms of the existing debt instrument.

470-20-40-14 A conversion includes an exchange of a convertible debt instrument for equity securities or ~~a combination of equity securities and other~~ consideration, whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt. The guidance in paragraphs 470-20-40-13 through 40-13A preceding paragraph ~~also applies to~~ includes conversions pursuant to amended or altered conversion privileges on such instruments, even though the right to amend the terms is ~~they are~~ literally provided in the terms of the existing debt instrument at issuance.

470-20-40-15 The changed terms may involve any of the following:

- a. A reduction of the ~~original~~ conversion price thereby resulting in the issuance of additional shares of stock
- b. An issuance of warrants or other securities not provided for in the conversion privileges provided in the terms of the existing instrument ~~original conversion terms~~
- c. A payment of cash or other consideration to those debt holders that convert during the specified time period.

The guidance in ~~the following~~ paragraph 470-20-40-16 does not apply to conversions pursuant to other changes in conversion privileges or to changes in terms of convertible debt instruments that are different from those described in this paragraph.

470-20-40-16 If a convertible debt instrument is converted ~~to equity securities of the debtor~~ pursuant to an inducement offer (see paragraph 470-20-40-13), the issuer debtor shall recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities and other consideration issuable pursuant to the conversion privileges provided in the terms of the existing instrument ~~original conversion terms~~. The fair value of the securities or other consideration shall be measured as of the date the inducement offer is accepted by the convertible debt holder. That date normally will be the date the debt holder converts the convertible debt ~~into equity securities~~ or enters into a binding agreement to do so. Until the debt holder accepts the offer, no exchange has been made between the issuer debtor and the debt holder. Example 1 (see paragraph 470-20-55-1B) illustrates the application of this guidance.

470-20-40-17 The guidance in the preceding paragraph 470-20-40-16 does not require recognition of gain or loss with respect to the shares (or other consideration) issuable pursuant to the conversion privileges provided in the terms original conversion privileges of the existing convertible debt instrument when additional securities, instruments, or assets are transferred to a debt holder to induce prompt conversion of the existing debt instrument to equity securities. In a conversion pursuant to the conversion privileges provided in the terms of the existing instrument original conversion terms, debt is settled extinguished in exchange for shares, cash (or other assets), or any combination of shares and cash (or other assets) equity pursuant to a preexisting contract that is already recognized in the financial statements, and no gain or loss is recognized upon conversion.

Implementation Guidance and Illustrations

> Illustrations

• > Example 1: Induced Conversions of Convertible Securities

470-20-55-1B The following ~~Cases~~ in paragraphs 470-20-55-3 through 55-9 illustrate application of the guidance in paragraph 470-20-40-16 for measuring an expense when a convertible debt instrument is converted pursuant to an inducement offer to induced conversions of convertible securities:

- a. Reduced conversion price for conversion ~~before determination date~~, increase in bond **fair value** (Case A)
- b. Reduced conversion price for conversion ~~before determination date~~, decrease in bond fair value (Case B).

470-20-55-1C The Cases in paragraphs 470-20-55-9A through 55-9J illustrate application of the guidance in paragraphs 470-20-40-13(b) and 470-20-40-13A for determining whether an inducement offer includes the issuance of all of the consideration (in form and amount) issuable pursuant to conversion privileges provided in the terms of the existing debt instrument:

- a. Offer to settle convertible debt instrument in cash and warrants (Case C)
- b. Offer to settle convertible debt instrument in cash and shares (Case D)
- c. Offer to settle convertible debt instrument in shares and warrants (Case E).

470-20-55-2 For simplicity, the face amount of each security is assumed to be equal to its carrying amount in the financial statements (that is, no original issue premium or discount exists).

• • > Case A: Reduced Conversion Price, Increase in Bond Fair Value for Conversion before Determination Date—Bond Fair Value Increased

470-20-55-3 On January 1, 19X4, Entity A issues a \$1,000 face amount 10 percent convertible bond maturing December 31, 20X3. The carrying amount of the bond in the financial statements of Entity A is \$1,000, and it is convertible into common shares of Entity A at a conversion price of \$25 per share. On January 1, 19X6, the convertible bond has a fair value of \$1,700. To induce convertible bondholders to convert their bonds promptly, Entity A reduces the conversion price to \$20 for bondholders that convert before February 29, 19X6 (within 60 days).

470-20-55-4 Assuming the market price of Entity A's common stock on the date of ~~conversion~~ the inducement offer was accepted is \$40 per share, the fair value of the incremental consideration that will be paid by Entity A ~~upon conversion~~ is calculated as follows for each \$1,000 bond that is converted before February 29, 19X6.

Value of securities issued ^(a)	\$ 2,000
Value of securities issued pursuant to original existing conversion privileges ^(b)	<u>1,600</u>
Fair value of incremental consideration	<u>\$ 400</u>

(a) Value of securities issued to debt holders is computed as follows:

Face amount	\$ 1,000
÷ New conversion price	÷ \$ <u>20</u> per share
Number of common shares issued upon conversion	50 shares
× Price per common share	× \$ <u>40</u> per share
Value of securities issued	<u>\$ 2,000</u>

(b) Value of securities issuable pursuant to ~~original existing~~ conversion privileges is computed as follows:

Face amount	\$ 1,000
÷ Original Existing conversion price	÷ \$ <u>25</u> per share
Number of common shares issuable pursuant to original existing conversion privileges	40 shares
× Price per common share	× \$ <u>40</u> per share
Value of securities issuable pursuant to original existing conversion privileges	<u>\$ 1,600</u>

470-20-55-5 Therefore, upon conversion, Entity A records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

	<u>Debit</u>	<u>Credit</u>
Convertible debt	\$1,000	
Debt conversion expense	400	
Common stock		\$1,400

· · > Case B: Reduced Conversion Price, Decrease in Bond Fair Value for Conversion before Determination Date—Bond Fair Value Decreased

470-20-55-6 On January 1, 19X1, Entity B issues a \$1,000 face amount 4 percent convertible bond maturing December 31, 20X0. The carrying amount of the bond in the financial statements of Entity B is \$1,000, and it is convertible into common shares of Entity B at a conversion price of \$25. On June 1, 19X4, the convertible bond has a fair value of \$500. To induce convertible bondholders to convert their bonds promptly, Entity B reduces the conversion price to \$20 for bondholders that convert before July 1, 19X4 (within 30 days).

470-20-55-7 Assuming the market price of Entity B's common stock on the date ~~of conversion~~ the inducement offer was accepted is \$12 per share, the fair value of the incremental consideration that will be paid by Entity B ~~upon conversion~~ is calculated as follows for each \$1,000 bond that is converted before July 1, 19X4.

Value of securities issued ^(a)	\$ 600
Value of securities issued pursuant to original <u>existing</u> conversion privileges ^(b)	<u>480</u>
Fair value of incremental consideration	<u>\$ 120</u>

(a) Value of securities issued to debt holders is computed as follows:

Face amount	\$ 1,000
÷ New conversion price	÷ <u>\$ 20</u> per share
Number of common shares issued upon conversion	50 shares
× Price per common share	× <u>\$ 12</u> per share
Value of securities issued	<u>\$ 600</u>

(b) Value of securities issuable pursuant to ~~original~~ existing conversion privileges is computed as follows:

Face amount	\$ 1,000
÷ <u>Original Existing</u> conversion price	÷ <u>\$ 25</u> per share
Number of common shares issuable pursuant to original <u>existing</u> conversion privileges	40 shares
× Price per common share	× <u>\$ 12</u> per share
Value of securities issuable pursuant to original <u>existing</u> conversion privileges	<u>\$ 480</u>

470-20-55-8 Therefore, upon conversion, Entity B records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

	<u>Debit</u>	<u>Credit</u>
Convertible debt	\$1,000	
Debt conversion expense	120	
Common stock		\$1,120

470-20-55-9 The same accounting would apply if, instead of reducing the conversion price, Entity B issued shares pursuant to a tender offer of 50 shares of its common stock for each \$1,000 bond surrendered to the entity before July 1, 19X4. See paragraph 470-20-40-14.

. . > Case C: Offer to Settle Convertible Debt Instrument in Cash and Warrants

470-20-55-9A On January 1, 2X24, Entity A issues a \$1,000 face amount 10 percent convertible bond maturing December 31, 2X33. The bond has a conversion price of \$25 per share. The terms of the existing instrument require that, upon conversion, the issuer settle the principal in cash and the conversion premium in any combination of cash and shares. Under the existing conversion privileges, the total amount of cash (or the total value of the cash and shares) required to be issued upon conversion equals the product of 40 shares per \$1,000 bond multiplied by a volume-weighted average price of Entity A's common stock. The volume-weighted average price is calculated over a period of 40 days beginning the day after the holder notifies the issuer that it will convert the debt instrument. On May 15, 2X27, to induce convertible bondholders to convert their bonds promptly, Entity A offers the following consideration in exchange for each \$1,000 bond that is converted within 60 days (for purposes of this Example, assume the offer meets the other criteria in paragraph 470-20-40-13 and that the offer is accepted by bondholders on June 1, 2X27):

- a. A cash payment equal to 40 shares multiplied by the volume-weighted average price of Entity A's common stock calculated over a period of 15 days (beginning the day after the holder accepts the inducement offer)
- b. Five warrants (offered as a sweetener). Each warrant enables the holder to acquire a share of Entity A's common stock at a fixed exercise price of \$40. The warrants are exercisable upon issuance and expire five years after issuance.

470-20-55-9B Assume that the fair value of Entity A's common stock on the date the inducement offer was accepted (June 1, 2X27) is \$40 per share. To evaluate whether the inducement offer meets the criterion in paragraph 470-20-40-13(b), Entity A would compare the form and amount of consideration offered with the form and amount of consideration that would be issued upon conversion pursuant to the terms of the existing instrument. The conversion privileges in the existing instrument require Entity A to settle the principal in cash and permit Entity A to settle the conversion premium in any combination of cash and shares.

470-20-55-9C In this Case, the inducement offer includes the form (entirely cash) and amount (\$1,600) of consideration required to settle both the principal (\$1,000) and the conversion premium (\$600) pursuant to the conversion privileges provided in the terms of the existing debt instrument. The amount of \$1,600 is the product of 40 shares multiplied by the fair value of Entity A's shares at the offer acceptance date (\$40).

470-20-55-9D The offer of warrants to induce conversion does not affect the assessment of whether the inducement offer includes the form and amount of consideration issuable under the existing conversion privileges because the existing conversion privileges did not provide for the issuance of warrants (however, the offer of warrants as a sweetener affects the measurement of the debt conversion expense recognized in accordance with paragraph 470-20-40-16). Similarly, the fact that the inducement offer changes the number of days over which the volume-weighted average price of Entity A's shares is measured 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 calculate the amount of cash payable under both the conversion privileges in the existing instrument and the inducement offer. Therefore, the inducement offer satisfies the criterion in paragraph 470-20-40-13(b).

[For ease of readability, the tables for Cases C and D are not underlined.]

Consideration Issuable Pursuant to Existing Conversion Privileges

Principal	
Cash	\$ 1,000
Conversion premium	
Any combination of cash and shares with a total value of \$600. If \$600 of the conversion premium is settled in cash, then the conversion premium would be settled as follows:	
Cash and	\$ 600
Shares ^(a)	0 shares

Consideration Issuable Pursuant to Inducement Offer

Cash and	\$ 1,600
Warrants	5 warrants

(a) Number of shares issuable pursuant to existing conversion privileges is computed as follows:

Value of 40 shares (40 shares × \$40 per share as of the offer acceptance date)	\$ 1,600
– Face amount	<u>– \$ 1,000</u>
Value of conversion premium	<u>\$ 600</u>
Value of conversion premium	\$ 600
Amount of conversion premium settled in cash	<u>– \$ 600</u>
Value of conversion premium to be settled in shares	<u>\$ 0</u>

. . > Case D: Offer to Settle Convertible Debt Instrument in Cash and Shares

470-20-55-9E Assume the same facts as Case C, except that Entity A offers the following consideration (instead of the consideration listed in paragraph 470-20-55-9A):

- a. A cash payment of \$1,400
- b. 10 shares of Entity A’s common stock.

470-20-55-9F To evaluate whether the inducement offer meets the criterion in paragraph 470-20-40-13(b), Entity A would compare the form and amount of consideration offered with the form and amount of consideration that would be issued upon conversion pursuant to the terms of the existing instrument. The conversion privileges in the terms of the existing instrument require Entity A to settle the principal in cash and permit Entity A to settle the conversion premium in any combination of cash and shares.

470-20-55-9G In this Case, the inducement offer includes the form (cash) and amount (\$1,000) of consideration required to settle the principal pursuant to the conversion privileges provided in the terms of the existing debt instrument. Under the existing conversion privileges, the remaining settlement value of \$600 can be settled in any combination of cash and shares. If \$400 (\$1,400

total cash payment - \$1,000 principal) of the conversion premium is settled in cash, then the inducement offer must provide for at least 5 shares (\$200 remaining conversion premium ÷ \$40 share price) of Entity A's common stock to provide the same form (cash and shares) and at least the same amount of cash and shares that would have been provided under the conversion privileges of the existing instrument. Because the inducement offer illustrated in Case D includes 10 shares, it would satisfy the criterion in paragraph 470-20-40-13(b). The fact that the inducement offer eliminates the volume-weighted average price 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 calculate the amount of cash payable and shares issuable under the conversion privileges in the existing instrument.

Consideration Issuable Pursuant to Existing Conversion Privileges

Principal	
Cash	\$ 1,000
Conversion premium	
Any combination of cash and shares with a total value of \$600. If \$400 of the conversion premium is settled in cash, then the conversion premium would be settled as follows:	
Cash and	\$ 400
Shares ^(a)	5 shares

Consideration Issuable Pursuant to Inducement Offer

Cash and	\$ 1,400
Shares	10 shares

(a) Number of shares issuable pursuant to existing conversion privileges is computed as follows:

Value of 40 shares (40 shares x \$40 per share as of the offer acceptance date)	\$ 1,600
- Face amount	- \$ 1,000
Value of conversion premium	<u>\$ 600</u>
Value of conversion premium	\$ 600
Amount of conversion premium settled in cash	- \$ 400
Value of conversion premium to be settled in shares	<u>\$ 200</u>
Value of conversion premium to be settled in shares	\$ 200
÷ Price per share (as of the offer acceptance date)	÷ \$ 40
Number of shares issued to satisfy conversion premium	<u><u>5 shares</u></u>

. . > Case E: Offer to Settle Convertible Debt Instrument in Shares and Warrants

470-20-55-9H Assume the same facts as Case C, except that Entity A offers the following consideration (instead of the consideration listed in paragraph 470-20-55-9A):

- a. 40 shares of Entity A's common stock
- b. Five warrants (offered as a sweetener). Each warrant enables the holder to acquire a share of Entity A's common stock at a fixed exercise price of \$40. The warrants are exercisable upon issuance and expire five years after issuance.

470-20-55-9I To evaluate whether the inducement offer meets the criterion in paragraph 470-20-40-13(b), Entity A would compare the form and amount of consideration offered with the form and amount of consideration that would be issued upon conversion pursuant to the terms of the existing instrument. The conversion privileges in the terms of the existing instrument require Entity A to settle the principal in cash and permit Entity A to settle the conversion premium in any combination of cash and shares.

470-20-55-9J In contrast to Case C and Case D, the inducement offer does not include the issuance of all the consideration (in form and amount) issuable pursuant to the conversion privileges included in the terms of the existing instrument. The terms of the existing instrument require settlement of the principal amount in cash, but Entity A did not offer cash consideration in the inducement offer. Therefore, Entity A would conclude that the criterion in paragraph 470-20-40-13(b) is not satisfied.

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2024-XX, Debt—Debt with Conversion and Other Options (Subtopic 470-20): Induced Conversions of Convertible Debt Instruments

470-20-65-4 The following represents the transition and effective date information related to Accounting Standards Update No. 2024-XX, *Debt—Debt with Conversion and Other Options (Subtopic 470-20): Induced Conversions of Convertible Debt Instruments*:

Effective date and early adoption

- a. All entities shall apply the pending content that links to this paragraph for fiscal years beginning after [date to be inserted after exposure] and interim periods within those fiscal years.
- b. Early adoption of the pending content that links to this paragraph [is or is not] permitted in any interim or annual period in which financial statements have not yet been issued (or made available for issuance), but [if permitted] no earlier than the adoption of the pending content that links to paragraph 815-40-65-1.

Transition method

- c. An entity shall apply the pending content that links to this paragraph prospectively to settlements of convertible debt instruments that occur during fiscal years (and interim periods within those years) beginning after the effective date.
- d. An entity may elect to apply the pending content that links to this paragraph retrospectively as of the beginning of the first comparative reporting period in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 45-10. This transition method shall be applied only to convertible debt instruments settled after the adoption of the pending content that links to paragraph 815-40-65-1.

Transition disclosures

- e. An entity that applies the pending content that links to this paragraph prospectively in accordance with (c) shall disclose the nature of and reason for the change in accounting principle in the financial statements of both the interim period (if applicable) and fiscal year of the change.
- f. An entity applying the pending content that links to this paragraph retrospectively in accordance with (d) shall provide the following transition disclosures in the financial statements of both the interim period (if applicable) and fiscal year of the change:
 - 1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle
 - 2. The method of applying the change
 - 3. 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 pending content that links to this paragraph is initially applied

4. 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.

Amendments to Subtopic 470-50

3. Amend paragraph 470-50-15-3, with a link to transition paragraph 470-20-65-4 as follows:

Debt—Modifications and Extinguishments

Scope and Scope Exceptions

> Transactions

470-50-15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Conversions of debt instruments ~~into equity securities of the debtor pursuant to conversion privileges provided in the terms of those instruments the debt at issuance.~~ Additionally, the guidance in this Subtopic does not apply to conversions of convertible debt instruments pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the existing terms of those debt instruments at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. Guidance on conversions of debt instruments (including induced conversions) is contained in paragraphs 470-20-40-4, 470-20-40-13, 470-20-40-13 and 470-20-40-15.
- b. Extinguishments of debt through a **troubled debt restructuring**. (See Section 470-60-15 for guidance on determining whether a modification or exchange of debt instruments is a troubled debt restructuring. If it is determined that the modification or exchange does not result in a troubled debt restructuring, the guidance in this Subtopic shall be applied.)

- c. Transactions entered into between a debtor or a debtor's agent and a third party that is not the creditor.

The amendments in this proposed Update were approved for publication by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Richard R. Jones, *Chair*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Frederick L. Cannon
Susan M. Cospers
Marsha L. Hunt
Dr. Joyce T. Joseph

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Task Force's considerations in reaching the conclusions in this proposed Update. It includes the Board's basis for ratifying the Task Force's conclusions when needed to supplement the Task Force's considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual Task Force and Board members gave greater weight to some factors than to others.

BC2. When the terms of a convertible debt instrument are changed to induce conversion of the instrument, current GAAP provides guidance for determining whether the transaction should be accounted for as an induced conversion (as opposed to a debt extinguishment). If the transaction is accounted for as an induced conversion, then an entity recognizes an expense only for the consideration in excess of what was issuable under the original conversion privileges. If the transaction is, instead, accounted for as an extinguishment, then an entity is required to recognize an extinguishment gain or loss for the difference between the reacquisition price and the net carrying amount of the extinguished debt instrument.

BC3. Under current GAAP, the guidance on induced conversions applies only to conversions that include the issuance of all the equity securities issuable pursuant to conversion privileges provided in the terms of the debt at issuance. Current GAAP does not address how this criterion should be applied to the settlement of a convertible debt instrument that does not require the issuance of equity securities upon conversion (for example, a convertible debt instrument with a cash conversion feature). Current GAAP also does not address how the incorporation, elimination, or modification of a VWAP formula interacts with this criterion, including when such changes could result in the holder receiving less cash or fewer shares than if the debt instrument had been settled in accordance with the conversion privileges provided in the terms of the instrument prior to any changes to induce conversion. Stakeholders have also noted that, under current GAAP, it is not clear whether the guidance on induced conversions can be applied to the early settlement of a convertible debt instrument that is not currently convertible.

BC4. The amendments in this proposed Update would clarify the requirements for determining whether certain settlements of convertible debt instruments should be accounted for as an induced conversion. Under the proposed amendments, to account for a settlement of a convertible debt instrument as an induced conversion, an inducement offer would be required to preserve the form and amount of consideration issuable under the conversion privileges provided in the terms of the instrument. An entity would assess whether this criterion is satisfied as of the date the inducement offer is accepted by the holder.

BC5. The amendments in this proposed Update also would make additional clarifications to assist stakeholders in applying the proposed guidance. Under the proposed amendments, the incorporation, elimination, or modification of a VWAP formula would not automatically cause a settlement to be accounted for as an extinguishment; an entity would instead assess whether the form and amount of conversion consideration are preserved using the fair value of an entity's shares as of the offer acceptance date.

BC6. Finally, the amendments in this proposed Update also would clarify that the induced conversion guidance can be applied to a convertible debt instrument that is not currently convertible as long as it had a substantive conversion feature as of its issuance date and is within the scope of the guidance in Subtopic 470-20.

Background Information

Settlements of Convertible Debt

BC7. Under existing guidance, three principal models are used to account for the settlement of convertible debt instruments within the scope of the guidance in Subtopic 470-20:

- a. Contractual conversion accounting, which has no income statement effect
- b. Induced conversion accounting, which has an income statement effect because it requires recognition of an expense equal to the fair value of the additional securities and other consideration issued to induce conversion

- c. Extinguishment accounting, which has an income statement effect equal to the difference between the reacquisition price of the extinguished debt and the net carrying amount of the debt (extinguishment gain or loss).

BC8. The objective of the amendments in this proposed Update is to improve the relevance of the existing induced conversion guidance in Subtopic 470-20. The proposed amendments focus on the applicability of the induced conversion guidance to the early settlement of convertible debt instruments.

Induced Conversions and Extinguishments of Convertible Debt

BC9. FASB Statement No. 84, *Induced Conversions of Convertible Debt*, established guidance for induced conversions or transactions in which a convertible debt instrument's conversion privileges are changed or additional consideration is paid to debt holders for the purpose of inducing prompt conversion of the debt into equity securities. Statement 84 stated that the changed terms may involve a reduction of the original conversion price (resulting in the issuance of additional equity shares), the issuance of instruments not provided for in the original conversion terms, or the payment of cash or other consideration to debt holders that convert during a limited period of time.

BC10. In Statement 84, the Board concluded that induced conversions represent settlement transactions distinct from extinguishments of convertible debt. Specifically, the Board noted that, in an induced conversion, the preexisting contract for conversion remains in effect and an inducement is paid to incentivize conversion into equity shares. By contrast, in an extinguishment, any preexisting contract between the issuer and the debt holder is effectively voided, and the debt is extinguished pursuant to newly negotiated terms.

BC11. The guidance in Statement 84 considered convertible debt instruments that were convertible into equity instruments; it did not consider convertible debt instruments that could be settled partly or wholly in cash in accordance with the conversion privileges provided in the terms of the instrument.

BC12. Accordingly, for a settlement to be accounted for as an induced conversion, Statement 84 required that it include the issuance of "all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted." This

requirement is currently codified in paragraph 470-20-40-13(b). Under this guidance, if a traditional convertible debt instrument (requiring the issuance of equity instruments upon conversion) is settled fully in cash (and, therefore, no equity instruments are issued), then the transaction would be accounted for as an extinguishment, rather than as an induced conversion.

Derecognition Requirements for Induced Conversions and Extinguishments

BC13. In an induced conversion, like in a contractual conversion, no extinguishment gain or loss is recognized upon settlement. Instead, in an induced conversion, an entity is required to recognize an inducement expense equal to the excess of (a) the fair value of all securities and other consideration transferred over (b) the fair value of securities issuable pursuant to the original conversion terms. The inducement expense is calculated using the applicable fair values as of the date the inducement offer is accepted by the holder.

BC14. Under this guidance, even if the fair value of the consideration paid to settle the convertible debt instrument is less than the debt's net carrying amount, an inducement expense (rather than a gain) would be recognized equal to the fair value of the consideration provided in excess of the fair value issuable under the original conversion privileges.

BC15. By contrast, if a settlement is accounted for as an extinguishment, then an extinguishment loss or gain is recognized in the period of extinguishment. The amount of the extinguishment loss (or gain) is calculated as the difference between (a) the reacquisition price of the extinguished debt and (b) the debt's net carrying amount. As a result, the amount of the extinguishment loss or gain recognized would comprise, in part, changes in the value of the conversion option (due to changes in the value of the entity's shares). In an induced conversion, the amount of the inducement expense recognized would not include the changes in the value of the conversion option.

Previous Guidance for Settlements of Convertible Debt Instruments with Cash Conversion Features

BC16. Prior to the issuance of the amendments in Update 2020-06, the Cash Conversion Subsections of Subtopic 470-20 provided guidance for certain convertible debt instruments that could be settled in cash upon conversion

(convertible debt instruments with cash conversion features). For instruments that were within the scope of those Subsections, there was also guidance for induced conversions with derecognition requirements upon settlement that differed from those established in Statement 84 for traditional convertible debt instruments.

BC17. While this guidance required recognition of an inducement loss that was calculated similarly to the inducement expense required by Statement 84, it also required the recognition of an extinguishment gain or loss for all derecognition transactions (regardless of whether the settlement was characterized as a “conversion” or an “extinguishment”). Under that guidance, an extinguishment gain or loss was calculated as the difference between the carrying amount of the liability and the fair value of the liability component (which excluded the value of the conversion option) immediately before extinguishment. Under that guidance, settlement of a debt instrument with a conversion option that had increased in value since issuance would have generally resulted in a reduction of equity, rather than an increase in the extinguishment loss recognized.

Amendments to the Guidance for Convertible Debt Instruments with Cash Conversion Features in Update 2020-06

BC18. The amendments in Update 2020-06 eliminated the Cash Conversion Subsections of Subtopic 470-20. In issuing that Update, the Board decided to simplify the accounting for convertible instruments by removing certain separation models (including the cash conversion model) for convertible instruments. As a result, for convertible instruments with conversion features that are not required to be accounted for as derivatives under Topic 815, Derivatives and Hedging, or that do not result in substantial premiums accounted for as paid-in capital, the embedded conversion features no longer are separated from the host contract. Consequently, a convertible debt instrument is required to be accounted for as a single liability measured at its amortized cost, because no other features require bifurcation and recognition as derivatives.

BC19. As a result of the amendments in Update 2020-06, convertible debt instruments with cash conversion features became subject to the same

guidance for contractual conversions as traditional convertible debt instruments.

BC20. The induced conversion guidance that was originally established by Statement 84 was not revised by the amendments in Update 2020-06. Therefore, convertible debt instruments with cash conversion features also became subject to the same guidance on induced conversions as traditional convertible debt instruments.

BC21. The amendments in Update 2020-06 also made changes to simplify the application of the diluted earnings per share (EPS) guidance for instruments that may be settled in cash or shares. In accordance with the amendments in Update 2020-06, in calculating diluted EPS, entities are required to assume share settlement for convertible debt instruments that provide the issuer with the ability to settle conversions in any combination of cash or shares. Consequently, such instruments often will be more dilutive than convertible debt instruments for which the principal is required to be cash settled and only the conversion premium is permitted to be settled in shares.

Issues Raised by Stakeholders

BC22. After the adoption of the amendments in Update 2020-06 by most public entities, stakeholders raised several issues encountered when trying to determine whether the guidance originally established in Statement 84 applied to certain settlements of convertible debt. These stakeholders explained that some of these issues arose because the guidance on induced conversions that was originally established in Statement 84 did not contemplate debt instruments with cash conversion features. Consequently, stakeholders have stated that it is unclear whether certain settlements of debt instruments with cash conversion features should be accounted for as induced conversions or as extinguishments.

BC23. Specifically, stakeholders asked whether the settlement of a convertible debt instrument that involved either changes to the form of settlement or the incorporation, elimination, or modification of a VWAP formula would be subject to induced conversion accounting. Stakeholders also noted that the current guidance in paragraph 470-20-40-13(b), which is consistent with the guidance in Statement 84, states that induced conversion accounting applies only to conversions that include the issuance of all the *equity securities* issuable pursuant to conversion privileges included in the terms of the debt at issuance.

Therefore, stakeholders indicated that it was not clear how this guidance would be applied to convertible debt instruments whose terms did not require the issuance of equity securities upon conversion.

BC24. Stakeholders also asked whether the induced conversion guidance could apply to instruments that are not currently convertible. Stakeholders acknowledged that this issue was relevant prior to the adoption of the amendments in Update 2020-06 and applies to both traditional convertible debt instruments and those with cash conversion features. However, for debt instruments with cash conversion features, there is a more significant difference between induced conversion accounting and extinguishment accounting after the adoption of the amendments in Update 2020-06 because of the elimination of the cash conversion model previously codified in Subtopic 470-20. This change prompted stakeholders to ask for clarification.

BC25. Statement 84 included guidance that “prior to an induced conversion of a convertible debt instrument, a debtor has outstanding convertible debt that is *(or will become)* convertible to equity securities of the debtor at the option of the debt holder” (emphasis added). However, this guidance was not incorporated into the Codification and also did not clearly specify whether it applied to an instrument for which the exercisability of its conversion option is conditioned on something other than the mere passage of time.

BC26. In response to this stakeholder feedback, at its April 26, 2023 meeting, the Board added a narrow-scope project to the Task Force’s agenda to improve the relevance of the induced conversion guidance in Subtopic 470-20 with a focus on clarifying the applicability of the induced conversion guidance to the early settlement of convertible debt instruments, including convertible debt instruments with cash conversion features.

Basis for Conclusions

Induced Conversions of Convertible Debt Instruments with Cash Conversion Features

BC27. The Task Force reached a consensus-for-exposure to clarify when the settlement of a convertible debt instrument would be accounted for as an induced conversion. Task Force members observed that the issues raised in this project were a result of the guidance in paragraph 470-20-40-13(b) that

was written before convertible debt instruments with cash conversion features and other adjustment features became prevalent in the market. Task Force members indicated that it is unclear how the existing guidance should be applied to convertible debt instruments with such features. Therefore, the amendments in this proposed Update to the induced conversion model are intended to both address the current questions being raised (including clarifying the guidance's application to debt instruments with cash conversion features) and provide a framework broad enough to address other questions that could arise in the future. Those proposed changes include the following:

- a. To be accounted for as an induced conversion, an inducement offer would be required to preserve the *form and amount of consideration* issuable upon conversion in accordance with the terms of the instrument (rather than only the *equity securities* issuable upon conversion).
- b. Whether a settlement of convertible debt would be accounted for as an induced conversion would be assessed as of the date the inducement offer is accepted by the holder.
- c. Issuers that have modified a convertible debt instrument within the preceding 12 months (that did not result in extinguishment accounting) would use the terms that existed 12 months before the inducement offer was accepted when determining whether induced conversion accounting should be applied.

Preservation of the Form and Amount of Consideration Issuable upon Conversion in an Inducement Offer

BC28. The Task Force reached a consensus-for-exposure that, to account for a settlement of convertible debt as an induced conversion, the inducement offer should include the *form and amount of consideration* issuable under the conversion privileges in the terms of the instrument. This proposed requirement would replace the existing requirement that states that to be accounted for as an induced conversion (rather than an extinguishment) an inducement offer should include the issuance of all the *equity securities* issuable pursuant to conversion privileges provided in the terms of the instrument.

BC29. The Task Force expects that the amendments in this proposed Update would clarify whether certain settlements of debt instruments with cash conversion features could apply induced conversion accounting.

BC30. For example, one common type of convertible debt instrument (often referred to as “Instrument C”) requires that the issuer, upon conversion, settle the principal amount of the debt in cash with an (issuer) option to settle any conversion premium in either cash or stock. Under the amendments in this proposed Update, if the entity (the issuer) offers to settle this instrument fully in cash, then it would assess whether the amount of cash offered includes at least the amount that would have been issuable under the conversion privileges included in the terms of the existing instrument. That is, the entity would assess whether the amount of cash offered is sufficient to satisfy both the amount of the principal and the conversion premium. If an entity concludes that the amount of cash issuable under the instrument’s conversion privileges is preserved by the offer, then it would assess the other existing criteria in paragraph 470-20-40-13 to determine whether induced conversion accounting applies (for example, that the transaction occurs pursuant to changed conversion privileges that are exercisable only for a limited period of time).

BC31. Conversely, if the entity offers to settle the same instrument fully in shares, then the transaction would be accounted for as an extinguishment because the form of the consideration issuable under the instrument’s conversion privileges would not be preserved by the offer. That is, the conversion privileges included in the terms of the instrument required settlement of the principal amount in cash, and the entity did not offer any cash as part of the settlement.

BC32. If the entity, instead, offers to settle the same instrument in a combination of cash and shares, then it would be required to assess whether the amount of cash and shares offered included at least the amounts issuable under the instrument’s conversion privileges. If the amount of cash offered is less than the amount of cash required to be issued under the instrument’s conversion privileges (because the amount of cash offered is less than the amount of the principal), then the transaction would be accounted for as an extinguishment. If the cash offered is sufficient to satisfy the principal amount, then the entity also would have to assess whether the amount of cash (and/or shares) offered is at least equal to the amount that would have been needed to satisfy the conversion premium amount under the instrument’s conversion privileges.

BC33. While Task Force members do not expect that this change would affect the assessment for convertible debt instruments that are required to be settled

fully in shares upon conversion, they expect that this would reduce existing diversity in practice for determining whether the settlement of debt instruments with cash conversion features should be accounted for as an induced conversion or an extinguishment.

BC34. Task Force members noted that the induced conversion guidance was established on the basis that an induced conversion differs from an extinguishment because it preserves the consideration that would have been issued in a contractual conversion. Under existing guidance, a settlement of a convertible debt instrument in which the form of consideration used to settle the instrument (for example, cash) differs from the form of consideration specified in the conversion privileges (for example, shares) is not eligible to be accounted for as a contractual conversion. Therefore, in developing the amendments in this proposed Update, Task Force members concluded that to qualify as an induced conversion, a transaction should include the issuance of all the consideration (in form and amount) that would be necessary to apply contractual conversion accounting. The Task Force observed that this would not limit the form or amount of any *additional* consideration offered to induce conversion.

BC35. Task Force members also emphasized that the form and amount of consideration specified in the conversion privileges provided in the terms of the instrument affect not only whether a settlement is accounted for as a conversion, but also how diluted EPS is calculated for the instrument while it is outstanding. For example, the Task Force did not want to allow entities to be able to issue instruments that require the settlement of the principal in cash but that would be eligible for induced conversion accounting if the principal was ultimately settled in shares. Task Force members expressed concern that this would provide entities with structuring opportunities that could result in entities (a) issuing convertible debt instruments that have a less dilutive EPS impact while outstanding and then (b) avoiding the often less favorable income statement impact of extinguishment accounting when the instrument is settled.

BC36. In summary, the Task Force concluded that while any revised guidance on induced conversions should be broadened to more clearly convey how it should be applied to debt instruments with cash conversion features, the preservation of the form and amount of consideration provided for in an instrument's conversion privileges should be a necessary criterion for a settlement to be considered an induced conversion.

BC37. The Task Force also considered, but ultimately dismissed, an approach that would have focused on whether the fair value of the consideration offered was incremental to the consideration issuable under the instrument's conversion privileges, regardless of whether the form of the consideration was preserved in the offer. The Task Force considered this alternative approach because it would have aligned the accounting for transactions that result in similar (or identical) economics. The Task Force also considered that this approach may be less complex than the selected approach because outcomes would not vary depending on whether the form of consideration provided for in an inducement offer aligned with the form provided for in an instrument's conversion privileges. However, the Task Force expressed concern that this approach would result in most settlements of convertible debt instruments being accounted for as induced conversions, would be inconsistent with how changes in form affect the application of contractual conversion accounting, and could give rise to structuring opportunities that would result in both a more favorable EPS treatment and a more favorable income statement effect upon settlement.

Assessment as of the Date the Inducement Offer Is Accepted

BC38. The Task Force reached a consensus-for-exposure that when determining whether the form and amount of the conversion consideration are preserved in an inducement offer, an entity should determine the amount of cash (or other assets) and number of shares that would be issued based on the fair value of the entity's shares as of the offer acceptance date. That is, the Task Force concluded that (a) an entity should assess whether a settlement would be accounted for as an induced conversion using the fair value of the relevant shares as of a specified point in time and (b) the specified point in time is the date the inducement offer is accepted by the convertible debt holder.

BC39. Under this approach, if the settlement is based on a future price or average of future prices, then an entity should use the fair value of the shares as of the date the inducement offer is accepted.

BC40. The Task Force decided that this would not apply to a calculation to the extent that the number of shares or cash issuable is dependent on a *past* (and therefore, known) share price because there would be little substantive

difference between a calculation based on a past share price and an offer based on a fixed-dollar amount.

BC41. For a traditional convertible debt instrument, the number of shares issuable may be fixed; therefore, an increase in the price of an entity's shares would not require the issuance of additional equity instruments or the payment of additional consideration. For those instruments, it would not be necessary to assess *as of a specified point in time* whether the form and amount of consideration provided in the conversion privileges are preserved. It would generally be clear whether an offer for a fixed number of shares provided at least the number of shares issuable under the conversion privileges included in the terms of the debt instrument, regardless as of which date this assessment was performed.

BC42. By contrast, for a debt instrument with cash conversion features, changes in the price of an entity's shares could affect the amount of cash or the number of shares issuable upon conversion. Under the typical conversion privileges for these types of instruments, the value of the consideration issuable upon conversion (in cash or a combination of cash and shares) will be the product of (a) the price of the shares and (b) a fixed number of shares. Therefore, a higher share price will result in more consideration being issued upon conversion than if the share price were lower. Consequently, the amount of consideration issuable will be directly affected by the date on which the share price is measured and the prevailing share price on that date.

BC43. Without additional clarifications, the Task Force was concerned that, prior to settlement, it would be unclear whether the form and amount of consideration would be preserved by an inducement offer when the instrument's conversion privileges, the inducement offer, or both use a future share price to determine the amount of consideration issuable. For example, if the issuer shortens the VWAP period from 30 days (in the conversion privileges provided in the terms of the instrument) to 5 days (in the inducement offer), then it is possible that the holder *could* receive less consideration than under the original terms, depending on the future share price.

BC44. Some stakeholders observed that VWAP formulas in convertible debt instruments are primarily used to ensure that the settlement of the convertible debt instrument is based on the average price of the underlying shares over a specified trading period. Debt holders often hedge their positions on convertible debt to mitigate their exposure to stock price volatility while the convertible debt

is outstanding. The inclusion of the VWAP formula gives the convertible debt holders the ability to unwind their hedges over a period of time, rather than on one specific date (when the share price on that date may not be representative of the share price over the period). Changes to the VWAP formula (including elimination of the VWAP formula or changes in the period of time over which the VWAP is calculated) may be modified at the request of the convertible debt holders, rather than initiated by the issuer for the purpose of inducing conversion. Therefore, in practice, some stakeholders asserted that VWAP formulas primarily represent settlement mechanisms and that changes to VWAP formulas are seldom designed to convey incremental value to the debt holder.

BC45. To address this issue, the Task Force reached a consensus-for-exposure that the form and amount of consideration that are issuable under both (a) the conversion privileges provided in the terms of the instrument and (b) the inducement offer should be compared using the fair value of the entity's shares as of the same point in time.

BC46. Therefore, if the only difference between (a) the instrument's conversion privileges and (b) the inducement offer (aside from any incremental consideration to induce conversion) is the date as of which the entity's share price is measured, then an entity would conclude that the amount of consideration issuable was preserved by the inducement offer. Consequently, under the amendments in this proposed Update, the incorporation, elimination, or modification of a VWAP formula would not automatically preclude the application of induced conversion accounting because of the possibility that less consideration could ultimately be issued than under the instrument's conversion privileges.

BC47. The Task Force also considered, but ultimately dismissed, an approach that would have required extinguishment accounting for any change to the conversion privileges that *could* result in the holders receiving less consideration. While this approach would be consistent with how some stakeholders interpret the existing requirements for induced conversions of debt instruments with cash conversion features, the Task Force concluded that it would result in settlement transactions being accounted for as extinguishments even though the changes are neither designed nor expected to have a significant effect on the value conveyed to the convertible debt holder.

BC48. The Task Force reached a consensus-for-exposure that an entity should determine the amount of cash and number of shares that would be issued as of the *offer acceptance date* (rather than a different date, such as the date the offer is made to the debt holder). Consistent with the Board’s decision in the basis for conclusions of Statement 84, the Task Force concluded that it would be appropriate to assess whether the form and amount of conversion consideration are preserved in an inducement offer as of the offer acceptance date because the fair values on that date are presumably what cause the transaction to occur. Task Force members also noted that this is consistent with the existing requirements for calculating the inducement expense (which is required to be measured as of the date the inducement offer is accepted by the convertible debt holder).

Application of a One-Year Look-Back to Convertible Debt Instruments Modified during the Preceding 12 Months

BC49. The Task Force reached a consensus-for-exposure that if within the 12 months leading up to the offer acceptance date the debt had been exchanged or modified without being deemed to be substantially different, then the conversion privileges that existed a year ago should be used in place of conversion privileges provided in the terms of the instrument (the “one-year look-back”) when evaluating the induced conversion criteria. Under this guidance, an entity would use the conversion price and any other key settlement terms as they would have existed at the offer acceptance date had the instrument not been exchanged or modified during the preceding 12 months.

BC50. The one-year look-back is designed to be similar to the guidance in paragraph 470-50-40-12(f). That existing guidance was developed for the purpose of applying the 10 percent cash flow test that is used to determine whether a modification or exchange of a debt instrument requires extinguishment accounting.

BC51. In the context of the induced conversion guidance, the Task Force concluded that it would be helpful to require the one-year look-back in conjunction with the requirements that the inducement offer preserve the form and amount of consideration issuable pursuant to the instrument’s conversion privileges. The Task Force noted that a modification to the required form of settlement would not be considered in the extinguishment test under the

existing guidance in Subtopic 470-50, Debt—Modifications and Extinguishments. Therefore, some Task Force members were concerned that without a look-back provision entities could modify convertible debt instruments to change the required form of consideration shortly before settlement and apply inducement accounting, rather than extinguishment accounting.

BC52. The Task Force considered, but decided not to proceed with, an approach that would have involved the development of a principle for determining whether any modifications made in contemplation of a settlement transaction should be combined with the settlement transaction for purposes of evaluating whether the settlement should be accounted for as an induced conversion. Some Task Force members referenced existing principles, such as the guidance in paragraph 815-10-15-9, that provide indicators for when two or more separate transactions should be viewed as a (single) unit. Some Task Force members also questioned the prevalence of modifications made to convertible debt instruments in contemplation of an inducement and therefore whether any guidance in this area (a bright-line look-back period or a principle) would be necessary.

BC53. The Task Force concluded that requiring a one-year look-back when there have been modifications in the past 12 months would help to disincentivize structuring designed to achieve specific accounting outcomes. It also concluded that a one-year look-back would be better aligned with existing guidance applicable to debt instruments and would not require as much judgment as the application of any principle that could be developed.

Application to Debt Instruments Not Currently Convertible

BC54. The Task Force reached a consensus-for-exposure that an entity should be able to apply induced conversion accounting to convertible debt instruments that are not currently convertible, as long as those instruments contained a substantive conversion feature as of the time of issuance and are within the scope of the guidance in Subtopic 470-20.

BC55. The Task Force considered that, under the existing guidance for induced conversions, an issuer can apply induced conversion accounting to a debt instrument with a conversion option that is out-of-the-money and is, therefore, unlikely to be exercised. The Task Force concluded that there is not a

significant enough difference between an instrument with unsatisfied contingencies that prevent exercisability of the conversion option and an instrument with a conversion option that is unlikely to be exercised because it is out-of-the-money to warrant different derecognition requirements.

BC56. Similarly, the Task Force noted that, under existing guidance, a convertible debt instrument may be issued with a market or nonmarket contingency that has not been resolved when the issuer exercises a call option on the convertible debt instrument (and the convertible debt instrument becomes convertible only because the issuer's call option was exercised). Upon the exercise of the issuer's call option, if a convertible debt instrument is determined to have had a substantive conversion feature as of the time of issuance, then it may be accounted for as a contractual conversion, even though the market and/or nonmarket contingencies had not been satisfied when the issuer's call option was exercised. The term *substantive conversion feature* is defined in Subtopic 470-20 as a conversion feature that is at least reasonably possible of being exercisable in the future absent the issuer's exercise of a call option. Although Task Force members acknowledged differences between an inducement offer and the issuer's exercise of a call option, they concluded that establishing similar guidance for both transactions would be appropriate in this circumstance.

BC57. Alternatively, the Task Force also considered, but ultimately dismissed, approaches that would have prohibited application of the induced conversion guidance to instruments that either (a) were not currently convertible or (b) were not currently probable of becoming convertible (for example, based on the existing probability threshold for share-based payment arrangements). However, the Task Force concluded that permitting an entity to apply induced conversion accounting to all convertible debt instruments that contained a substantive conversion feature as of the time of issuance was more consistent with current guidance applicable to convertible debt instruments.

BC58. The Task Force also considered if entities should assess whether a conversion feature was substantive as of a date other than issuance (for example, as of the date the inducement offer is accepted by the holder). However, the Task Force concluded that permitting an entity to apply induced conversion accounting to all convertible debt instruments that contained a substantive conversion feature as of the time of issuance would be more consistent with current guidance in Subtopic 470-20.

Transition and Transition Disclosures

BC59. The Task Force reached a consensus-for-exposure that the amendments in this proposed Update could be applied using either a prospective approach or a retrospective approach because the Task Force does not expect that the benefits of requiring retrospective application would justify the incremental costs to all entities. The Task Force noted that retrospective application would only apply to instruments settled after the adoption of the amendments in Update 2020-06, which would diminish some of the comparability benefits that are normally associated with retrospective application. Also, the Task Force considered that if the guidance were required retrospectively, then preparers would have to explain (and investors or other allocators of capital would have to understand) the effect of adopting the guidance on already derecognized convertible debt instruments that do not have any effect on an entity's future cash flows. Furthermore, in the context of other projects (for example, the Board's project on targeted improvements to the accounting for long-duration insurance contracts), stakeholders have indicated that there can be a significant burden on both preparers and practitioners to apply new guidance to derecognized arrangements.

BC60. The Task Force reached a consensus-for-exposure to require transition disclosures for entities electing to apply the guidance retrospectively that are generally consistent with the disclosures required for entities that apply the amendments in Update 2020-06 using the full retrospective method of adoption. The Task Force reached a consensus-for-exposure to require that entities that apply the guidance prospectively disclose the nature of and reason for the change in accounting principle.

Benefits and Costs

BC61. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other allocators of capital benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than

quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC62. The Board does not anticipate that entities will incur significant costs as a result of the amendments in this proposed Update. Moreover, because the proposed amendments would clarify how to account for the settlement of certain convertible debt instruments going forward, the Board expects that the proposed amendments would reduce the cost of determining how to account for those transactions. The proposed amendments would facilitate consistent application of GAAP by clarifying guidance on when the existing derecognition requirements for an induced conversion should be applied to settlements of convertible debt instruments, including convertible debt instruments with cash conversion features. The proposed amendments would not create new disclosure requirements (other than upon transition) and are not expected to require entities to gather new or incremental information to apply.

Amendments to the GAAP Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require improvements to the GAAP Financial Reporting Taxonomy and SEC Reporting Taxonomy (collectively referred to as the “GAAP Taxonomy”). We welcome comments on these proposed improvements to the GAAP Taxonomy at xbrled@fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, the proposed improvements to the GAAP Taxonomy will be finalized as part of the annual release process.