

Ms. Hillary Salo  
Chair of the Emerging Issues Task Force  
Financial Accounting Standards Board  
801 Main Avenue  
P.O. Box 5116  
Norwalk, CT 06856-5116

## **Agenda Request – Distinguishing Between Induced Conversions and Extinguishments of Convertible Debt Instruments**

We appreciate the opportunity to submit an agenda request to the Emerging Issues Task Force (EITF). We request that the EITF address when induced conversion accounting applies to certain settlements of convertible debt instruments that occur on terms that differ from the stated contractual conversion provisions.

### **Background**

Following the issuance of FASB ASU 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* ("ASU 2020-06"), constituents have raised questions about the accounting for certain settlements of convertible debt instruments that do not occur in accordance with the contractual conversion terms of such instruments. These questions primarily relate to convertible debt instruments whose terms permit the issuer to settle conversions partly or wholly in cash (i.e., instruments with cash conversion features, or "CCFs"), but some of the issues described below are not limited to such instruments<sup>1</sup>.

Some of the issues described below were relevant before ASU 2020-06. However, the difference between induced conversion accounting and extinguishment accounting is often more significant to an entity's financial statements after the adoption of ASU 2020-06 because of the elimination of the CCF subsections of ASC 470-20, *Debt: Debt with Conversion and Other Options*. Before ASU 2020-06, all entities that settled convertible debt with CCFs were required to both (1) calculate an extinguishment gain or loss based on the difference between the carrying amount of the liability component and the current fair value of similar debt without a conversion feature and (2) recognize the settlement of the conversion feature in equity. That is, settlements involved both extinguishment accounting and conversion accounting. Conversely, after ASU 2020-06, extinguishment accounting does not apply to settlements of convertible debt pursuant to their contractual conversion terms. However, when extinguishment accounting applies, the gain or loss on extinguishment is now calculated based on the difference

---

<sup>1</sup> In practice, the most common types of convertible debt instruments with CCFs are referred to as "Instrument C" and "Instrument X." Instrument C requires the issuer to satisfy the accreted value of the obligation (i.e., the amount accrued to the benefit of the holder exclusive of any excess conversion spread) in cash and allows the issuer to satisfy the excess conversion value in either cash or shares. Instrument X permits the issuer to satisfy conversions in any combination of cash or shares.

between the carrying amount of the convertible debt instrument and the fair value of the consideration issued on settlement (which takes into account the value of the conversion feature). Therefore, the conversion value of the debt can result in significant gains or losses on extinguishment. Appendix A illustrates the difference between induced conversion accounting and extinguishment accounting after adoption of ASU 2020-06.

### **Accounting Models**

Under U.S. GAAP, as amended by ASU 2020-06, the following models apply to settlements of convertible debt instruments that are not troubled debt restructurings<sup>2</sup>:

- Conversion accounting:

Conversion accounting applies when settlement occurs pursuant to the stated terms of a substantive conversion feature<sup>3</sup>. The settlement consideration may consist of cash, shares, or a combination thereof (i.e., settlement could be entirely in cash for some convertible debt instruments with CCFs). In accordance with ASC 470-20-40-4, no gain or loss is recognized on conversion of a convertible debt instrument that is presented entirely as a liability regardless of the form of settlement<sup>4</sup>.

- Extinguishment accounting:

Extinguishment accounting applies when (1) settlement of convertible debt is not subject to conversion accounting or (2) there is a substantial modification of a convertible debt instrument. The settlement consideration may consist of cash, shares, or a combination thereof. In accordance with ASC 470-50-40-3 and 40-4, an extinguishment gain or loss is recognized for the difference between the fair value of the consideration transferred and the net carrying amount of the debt.

- Induced conversion accounting:

Induced conversion accounting applies to conversions of convertible debt pursuant to terms that reflect changes made to the original conversion privileges for the purpose of inducing conversion. Induced conversion accounting may be applied only if the conditions in ASC 470-20-40-13 through 40-15 are met and the settlement

---

<sup>2</sup> See Appendix B for excerpts from the FASB Accounting Standards Codification.

<sup>3</sup> The FASB Codification does not specifically define "conversion accounting." However, based on practice, we understand that the guidance in ASC 470-20-40-4 applies when a convertible debt instrument (whose conversion feature is not bifurcated as an embedded derivative) is settled for cash and/or shares in accordance with the stated terms of an equity conversion feature.

<sup>4</sup> A charge to earnings would occur if there was a separately recognized equity component for the instrument; however, as discussed below this paper assumes that no such equity component exists.

would otherwise be subject to conversion accounting<sup>5</sup>. The settlement consideration may consist of cash, shares, or a combination thereof. In accordance with ASC 470-20-40-16, the issuer must recognize an expense equal to the fair value of the securities and other consideration transferred in excess of the fair value of the shares issuable pursuant to the instrument's original conversion privileges. After that expense is recognized, the issuer applies conversion accounting.

A settlement is subject to induced conversion accounting, regardless of whether (1) the settlement involves legal exercise of the contractual conversion privilege included in the terms of the debt or (2) the conversion feature is out-of-the-money<sup>6</sup>, if the following conditions in ASC 470-20-40-13 through 40-15 are met:

- The convertible debt's original terms contained a substantive conversion feature.
- Either the issuer or holder has offered revised conversion terms that include additional consideration (e.g., additional shares, cash, warrants, or other securities) to incentivize the holder to convert the debt early.
- The changed conversion terms are exercisable only for a limited period.
- For each instrument converted, all equity securities that were issuable in accordance with the instrument's original conversion terms were issued (i.e., the conversion cannot result in the issuance of fewer shares than required to be issued in accordance with the original conversion terms).

## **Issues**

For purposes of the issues discussed below, it is assumed that that (1) the conversion feature is not bifurcated as an embedded derivative, (2) the convertible debt instrument is not recognized at fair value through earnings, and (3) there is no separately recognized equity component for the convertible debt instrument.

***Issue 1: Can induced conversion accounting apply if the cash or shares issued on conversion is calculated in a manner that differs from the original stated conversion privileges because a volume-weighted average price ("VWAP") formula is incorporated, eliminated, or modified?***

Assume an entity makes a limited time offer to holders of convertible debt to provide additional consideration (a premium) if they convert their instruments early. The consideration paid by the entity will be entirely in cash, which is a settlement alternative included in the original terms of the instrument. The offer either:

---

<sup>5</sup> Induced conversion accounting may not be applied if the settlement is required to be accounted for as an extinguishment.

<sup>6</sup> Case B in ASC 470-20-55-6 through 55-9 illustrates the application of induced conversion accounting to a convertible bond whose conversion feature is out-of-the-money.

- incorporates a VWAP formula that is used to calculate the excess conversion spread when the original conversion terms did not contain such a provision,
- eliminates a VWAP formula that is included in the instrument's stated terms,
- shortens the VWAP period from the stated VWAP formula in the contractual terms of the instrument (e.g., the contractual conversion terms refer to a 30-day VWAP period to calculate the excess conversion value and the early settlement involves a 5-day VWAP period), or
- otherwise changes the VWAP formula that is included in the instrument's stated terms.<sup>7</sup>

#### View A

No. Proponents of View A believe that even though there is a premium offered to induce holders to convert early, the incorporation of, elimination, or change to, the VWAP formula could result in the holders receiving less consideration than if they had converted the instrument pursuant to its original conversion terms. For example, when the VWAP period is shortened and/or the percentage of shares to which it applies is reduced, if the entity's stock price increases during the original VWAP period, holders could receive less value under the amended terms than if they had converted under the original terms of the instrument. Proponents of View A do not believe that the probability of receiving less value is a relevant consideration. Furthermore, proponents of View A note that ASC 470-20-40-15 does not refer to changes in the calculation of the consideration paid on settlement. Therefore, induced conversion accounting does not apply because the condition in ASC 470-20-40-13(b) is not met.

#### View B

Yes. Proponents of View B believe this transaction can qualify for induced conversion accounting because (1) it involves early conversion of the instrument (and therefore is consistent with the reason for induced conversion accounting, which is to induce holders to convert the instrument early) and (2) *at the date the offer is made*, the consideration transferred includes a premium to the stated conversion terms. Proponents of View B note that the changes to the stated settlement terms occur solely to accelerate conversion. Furthermore, proponents of View B do not believe an entity needs to consider what could happen between the offer date and the settlement date pursuant to either the amended or original conversion terms of the instrument.

#### View C

---

<sup>7</sup> Actual situations in practice are often more complex. For example, the original conversion terms might include a VWAP formula, whereas the offered terms might include elimination of the VWAP formula. Alternatively, instead of the VWAP formula applying to the full conversion value, it might only apply to a percentage of the shares (e.g., 95%). In some cases, both the VWAP period and the percentage of shares to which it applies are changed (usually both are reduced).

It depends. Proponents of View C believe that induced conversion accounting is appropriate if the fair value of the consideration *at the date the offer is accepted* exceeds the consideration pursuant to the original conversion privileges. Otherwise, extinguishment accounting applies. Proponents of View C do not believe an entity needs to consider what could happen between the offer acceptance date and the settlement date pursuant to either the amended or original conversion terms of the instrument.

***Issue 2: Can induced conversion accounting apply if the form of the consideration issued on settlement (ignoring the additional consideration or premium) differs from the contractual conversion terms?***

Assume an entity settles a convertible debt instrument entirely in shares and the contractual conversion terms require settlement of the accreted value in cash (i.e., Instrument C). Alternatively, assume a convertible debt instrument requires a contractual conversion to be settled entirely in shares and the issuer satisfies a portion of the contractual conversion in cash.

View A

No. ASC 470-20-40-13 requires the settlement include “the issuance of all of the equity securities issuable pursuant to [original] conversion privileges” even if the total consideration exceeds the fair value of the consideration issuable pursuant to the original conversion privileges. Proponents of View A believe that after the adoption of ASU 2020-06 when the settlement of a conversion option may be in shares or cash, the form of the consideration specified in the original terms of the convertible debt instrument must be issued or paid in order to apply induced conversion accounting. Therefore, induced conversion accounting cannot be applied if an entity either:

- satisfies a portion of a conversion in cash and the instrument required such portion to be settled in shares, or
- satisfies a portion of a conversion in shares and the instrument required such portion to be settled in cash (e.g., share settlement of the principal amount of an Instrument C convertible debt instrument).

Proponents of View A believe that ASC 470-20-40-13 indicates that the form of consideration issued on settlement is important to the analysis. Therefore, although not explicitly addressed in U.S. GAAP, induced conversion accounting cannot be applied if an entity settles the principal amount of a convertible debt instrument in shares and the contractual conversion terms required such amount to be settled in cash.

View B

Yes. Proponents of View B believe that after the amendments made by ASU 2020-06, the form of consideration used to satisfy a contractual conversion feature is not determinative of whether an induced conversion has occurred. This is supported by ASC

470-20-40-4, which allows conversion accounting in certain circumstances for which the settlement is entirely in cash. This view is also supported by ASC 470-20-40-15, which disregards whether the contractual conversion feature was legally exercised. Proponents of View B believe that the underlying principle in ASC 470-20-40-13 is that the issuer must provide additional consideration beyond the contractual conversion terms to apply induced conversion accounting. That is, if the issuer pays an amount more than the stated conversion value to settle a convertible debt instrument, the transaction may represent an induced conversion. Proponents of View B acknowledge that the wording in ASC 470-20-40-13 that refers to “the issuance of all the equity securities” has not been updated to reflect the guidance in ASU 2020-06 and the nature of convertible debt instruments that exist in today’s marketplace.

#### View C

It depends. Proponents of View C agree with View A that the language “issuance of all the equity securities” in ASC 470-20-40-13 precludes induced conversion accounting if an entity satisfies a portion of a conversion in cash and the instrument required such portion to be settled in shares. However, proponents of View C note that there is no prohibition on applying induced conversion accounting if an entity satisfies a portion of a conversion in shares and the instrument required such portion to be settled in cash. Therefore, induced conversion accounting is not precluded just because the principal or accreted value of an Instrument C convertible debt instrument is settled in shares.

#### ***Issue 3: Can induced conversion accounting apply to the settlement of a convertible debt instrument that is not currently convertible?***

#### View A

No. Proponents of View A believe that a settlement cannot be considered a conversion if the instrument was not convertible at the settlement date. Since the transaction is not a conversion for accounting purposes, extinguishment accounting must be applied.

#### View B

Yes. Proponent of View B note that the guidance on induced conversions does not refer to whether the instrument is currently convertible; therefore, such characteristic is not relevant. Rather, the early settlement of a convertible debt instrument is consistent with the concepts of induced conversion accounting. Proponents of View B note that View A would have the effect of requiring extinguishment accounting to transactions that substantively reflect conversions, which is inappropriate.

Yours truly,

Deloitte & Touche LLP

Ernst & Young LLP

KPMG LLP

PricewaterhouseCoopers LLP

## **Appendix A – Illustration of Differences Between Induced Conversion and Extinguishment Accounting**

### **Example 1: Conversion Feature is “In-the-Money”**

ABC Corp. has convertible debt outstanding with a \$1,000 net carrying amount. The if-converted value of the debt is \$1,500. ABC Corp. settles the instrument in a transaction in which \$100 of additional consideration is provided to the holder.

If extinguishment accounting is applied, ABC Corp. recognizes a *loss of \$600* (i.e., \$1,600 - \$1,000). If induced conversion accounting is applied, ABC Corp. recognizes a *loss of \$100* equal to the additional consideration provided.

### **Example 2: Conversion Feature is “Out-of-the-Money”**

XYZ Corp. has convertible debt outstanding with a \$1,000 net carrying amount. The if-converted value of the debt is \$500. XYZ Corp. settles the instrument in a transaction in which \$100 of additional consideration is provided to the holder.

If extinguishment accounting is applied, XYZ Corp. recognizes a *gain of \$400* (i.e., \$1,000 - \$600). If induced conversion accounting is applied, ABC Corp. recognizes a *loss of \$100* equal to the additional consideration provided.

## **Appendix B – Relevant FASB Accounting Standards Codification Guidance**

### **Conversion Accounting**

**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.

### **Extinguishment Accounting**

**470-50-40-3** In an early extinguishment of debt through exchange for common or preferred stock, the reacquisition price of the extinguished debt shall be determined by the value of the common or preferred stock issued or the value of the debt — whichever is more clearly evident.

**470-50-40-4** The extinguishment of convertible debt does not change the character of the security as between debt and equity at that time. Therefore, a difference between the cash acquisition price of the debt and its net carrying amount shall be recognized currently in income in the period of extinguishment as losses or gains.

### **Induced Conversion Accounting**

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

- a. 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)
- b. 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, regardless of the party that initiates the offer or whether the offer relates to all debt holders.

**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 preceding paragraph also includes conversions pursuant to amended or altered conversion privileges on such instruments, even though they are literally provided in the terms of the debt 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 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 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 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 issuable pursuant to the 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 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 does not require recognition of gain or loss with respect to the shares issuable pursuant to the original conversion privileges of the convertible debt when additional securities or assets are transferred to a debt holder to induce prompt conversion of the debt to equity securities. In a conversion pursuant to original conversion terms, debt is extinguished in exchange for equity pursuant to a preexisting contract that is already recognized in the financial statements, and no gain or loss is recognized upon conversion.