

# EITF Update

EITF meeting highlights

## September 2023 meeting highlights

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Members of the Emerging Issues Task Force (EITF or Task Force) reached the following consensus-for-exposure that is subject to ratification by the Financial Accounting Standards Board (FASB) at its 4 October 2023 meeting:

- ▶ Issue 23-A: The Task Force considered two approaches for entities to determine how to apply the induced conversion guidance to cash convertible debt instruments and decided on the preexisting contract approach. Under this approach, only conversions that include the issuance of all the consideration (both in form and amount) specified in the conversion privileges in the original debt terms are accounted for as induced conversions. The Task Force decided on some clarifications and made other decisions for applying the preexisting contract approach to cash convertible debt instruments.

## Consensus-for-exposure

### Issue 23-A: Induced Conversions of Convertible Debt Instruments

#### **What's the issue?**

*The guidance on accounting for induced conversions of convertible debt instruments was established in Financial Accounting Standards (FAS) No. 84 (FAS 84) (codified in Accounting Standards Codification (ASC) 470-20). The guidance did not contemplate cash convertible debt instruments. Accounting Standards Update (ASU) 2020-06<sup>1</sup> clarified that cash convertible debt instruments are subject to the same contractual conversion guidance in ASC 470-20-40-4<sup>2</sup> as traditional convertible debt instruments, but no amendments were made to the induced conversion guidance.*

*Cash convertible debt instruments have certain features that are generally not present in traditional convertible debt instruments, such as a stated volume-weighted average price (VWAP) period for determining the settlement amount (i.e., under net share or cash settlement). Stakeholders have raised questions about how the induced conversion guidance would be applied to cash convertible debt instruments, specifically when settlements of convertible debt instruments do not occur in accordance with the contractual conversion provisions (e.g., shortening the VWAP period from the original convertible debt) and whether such a change could potentially result in extinguishment rather than induced conversion accounting.*

*Under extinguishment accounting, a gain or loss is recognized for the difference between the fair value of the consideration transferred (which includes the value of the conversion feature) and the net carrying amount of the debt. Under induced conversion accounting, an entity does not recognize a gain or loss with respect to the shares issuable pursuant to the original conversion privileges of the convertible debt. Instead, an entity is required, upon conversion, to 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 (i.e., an expense is only recognized for the sweetener provided to induce the holder to convert). As a result, there could be significant differences in the accounting for the same transaction, depending on whether extinguishment accounting or induced conversion accounting is applied.*

The Task Force reached a consensus-for-exposure that would require entities to apply the preexisting contract approach when accounting for induced conversions of cash convertible debt instruments. Under this approach, ASC 470-20-40-13(b)<sup>3</sup> would be amended to require that an inducement offer preserve the form and amount of consideration issuable pursuant to the original conversion privileges.

The Task Force provided the following clarifications under the preexisting contract approach:

- ▶ To determine whether the amount of cash (or combination of cash and shares) issuable under the original conversion privileges is preserved by the inducement offer, an entity should determine the amount based on the fair value of its shares as of the offer acceptance date.
  - ▶ The issuer does not need to consider whether there is any possibility that the holders could receive less cash or fewer shares than if they had converted under the original terms. This means that the incorporation, elimination or modification of a VWAP period wouldn't necessarily mean that an entity cannot apply induced conversion accounting.

- ▶ If there has been an exchange or modification of the convertible debt that is not accounted for as a substantial modification (i.e., an extinguishment) under ASC 470-50 in the year leading up to the offer acceptance date, an entity would use the terms of the convertible debt that existed a year ago instead of the terms of the debt at issuance for purposes of determining whether it can apply induced conversion accounting.

In addition, the Task Force decided that induced conversion accounting can apply to all convertible debt instruments that have a substantive conversion feature at the time of issuance and are within the scope of the guidance in ASC 470-20, regardless of whether the instrument is currently convertible or not. For example, a debt instrument that is contingently convertible upon the occurrence of an event that has not yet occurred (such as upon an issuer's exercise of a call option) would be in the scope of the guidance if the conversion feature is substantive at the time of issuance.

The Task Force's decisions align with the principle established in FAS 84, which states that "in an induced conversion, the preexisting contract for conversion remains in effect and an inducement is paid in an attempt to cause the conversion option to be exercised."<sup>4</sup>

The Task Force considered but rejected an alternative approach called the incremental fair value approach, which focuses on whether the fair value of the consideration transferred in the transaction is greater than the fair value of the consideration the holder would be entitled to under the original conversion privileges (regardless of the forms of consideration the original terms permit upon conversion).

#### ***Effective date and transition***

An entity would be required to adopt any final guidance prospectively to convertible debt instruments settled after the effective date and would have the option to apply that guidance retrospectively to instruments settled after the adoption of ASU 2020-06.

If an entity elects to only apply any final guidance prospectively, the entity would be required, in the period of adoption, to disclose the nature of and reason for the change in accounting principle.

If the entity adopts any final guidance retrospectively, it would be required to disclose:

- ▶ The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle
- ▶ The method of applying the change
- ▶ The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance would be initially applied
- ▶ The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for any prior periods that are retrospectively adjusted

The Task Force will discuss an effective date after it considers feedback on the consensus-for-exposure.

## Endnotes:

- <sup>1</sup> 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)
- <sup>2</sup> ASC 470-20-40-4 (after adoption of ASU 2020-06): “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.”
- <sup>3</sup> ASC 470-20-40-13(b) (after adoption of ASU 2020-06): “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.”
- <sup>4</sup> Paragraph 25 of FAS 84

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