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EITF Snapshot
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In This Issue

Summary of the June Meeting of the Emerging Issues Task Force

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This *EITF Snapshot* summarizes the June 15, 2023, meeting of the Emerging Issues Task Force ("EITF" or "Task Force"). Initial Task Force consensuses (consensuses-for-exposure) are exposed for public comment upon ratification by the Financial Accounting Standards Board (FASB). After the comment period, the Task Force considers comments received and redeliberates the issues at a scheduled meeting to reach a final consensus. Those final consensuses are then provided to the FASB for final ratification and, ultimately, issuance as an Accounting Standards Update (ASU).

The official EITF minutes will be posted to the Deloitte Accounting Research Tool (DART) and to the FASB's Web site (note that the official EITF minutes may contain details that differ from those in this publication). EITF meeting materials (released before the meeting and used to frame the discussion) are also available on those sites.

Issue 23-A, "Induced Conversions of Convertible Debt Instruments"

Status: Initial deliberations.

Affects: Entities that enter into arrangements involving convertible debt instruments settled in accordance with conversion terms that differ from the originally stated contractual conversion provisions.

Background: The EITF meeting memo indicates that a convertible debt instrument is a legal-form debt security that can be converted into shares of "the issuer or an affiliated company at a specified price at the option of the holder." The types of convertible debt instruments, as well as the features included in these instruments, can vary. For example, there are convertible debt instruments that can be (1) settled with a combination of shares and cash or (2) fully settled in cash. Historically, different types of convertible debt instruments have been summarized, for example, in SEC speeches and EITF Issue 90-19.[1] The meeting memo describes these different types of instruments as follows:

> (a) **Traditional Convertible Debt:** Upon conversion, the issuer *must* satisfy the obligation entirely in shares based on a fixed number of shares into which the debt instrument is convertible.
>
> (b) **Instrument A:** Upon conversion, the issuer *must* satisfy the obligation entirely in cash based on a fixed number of shares multiplied by the stock price on the date of conversion (conversion value).
>
> (c) **Instrument B:** Upon conversion, the issuer *may* satisfy the entire obligation in either all stock or all cash (or cash equivalents) in an amount equal to the conversion value.
>
> (d) **Instrument C:** Upon conversion, the issuer *must* satisfy the accreted value of the obligation in cash and *may* satisfy the conversion spread (the excess conversion value over the accreted value) in either cash or stock.
>
> (e) **Instrument X:** Upon conversion, the issuer *may* settle the conversion value of the debt in shares, cash, or any combination of shares and cash. [Footnotes omitted]

In August 2020, the FASB issued ASU 2020-06.[2] Before the issuance of this ASU,[3] entities that settled convertible debt instruments with cash conversion features were required to (1) calculate an extinguishment gain or loss equal to the difference between the carrying amount of the liability component and the fair value of similar debt without a conversion feature and (2) recognize the settlement of the conversion feature in equity.

ASU 2020-06 amends ASC 470-20[4] to allow entities to apply conversion accounting to settlements of convertible debt instruments in accordance with their original contractual conversion terms. However, entities would apply extinguishment accounting to any convertible debt instruments settled whose terms differ (or are modified) from the original contractual conversion terms. Such entities are now required to (1) calculate an extinguishment gain or loss equal to the difference between the carrying amount of the convertible debt instrument and the fair value of the consideration issued on settlement and (2) recognize that difference in gain or loss. As a result of the amendments being made by ASU 2020-06, entities can apply conversion accounting to convertible debt instruments settled in either form (i.e., cash, shares, or a combination of both) as long as the instrument is converted in accordance with its original contractual conversion terms.

ASC 470-20 also includes a model for induced conversions, specifically for "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."[5] Entities may, from time to time, offer a "sweetener" to entice convertible debt instrument holders to settle their note before the end of the instrument's term. The induced conversion model requires entities to recognize an expense for the sweetener provided to induce the holder

[1] EITF Issue No. 90-19, "Convertible Bonds With Issuer Option to Settle for Cash Upon Conversion."

[2] FASB Accounting Standards Update No. 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*.

[3] For public business entities that are not smaller reporting companies, ASU 2020-06 is effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. The guidance may be early adopted for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. For convertible instruments that include a down-round feature, entities may early adopt the amendments that apply to down-round features if they have not yet adopted the amendments in ASU 2017-11, *Earnings per Share (Topic 260); Distinguishing Liabilities From Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments With Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception*.

[4] FASB Accounting Standards Codification (ASC) Subtopic 470-20, *Debt: Debt With Conversion and Other Options*.

[5] Quoted text is from ASC 470-20-40-13.

to convert. However, the entity will not recognize a gain or loss for the shares issuable in accordance with the original conversion terms of the convertible debt instruments, since conversion accounting will apply.

Stakeholders have expressed concerns that when convertible debt instruments are cash-settled in accordance with conversion terms that differ from the original contractual conversion terms, it is difficult for stakeholders to determine whether to apply induced conversion accounting or extinguishment accounting after the adoption of ASU 2020-06. Although the definition of conversion accounting, as amended by ASU 2020-06, remains indifferent regarding the form of settlement, the induced conversion model still only applies to the conversion of convertible debt instruments to "equity securities." Accordingly, given the amendments made by ASU 2020-06, stakeholders have asked the Board to provide guidance on when either induced conversion accounting or extinguishment accounting applies to settlements of convertible debt instruments whose terms differ from the original contractual conversion terms.

At its April 26, 2023, meeting, the FASB decided to add a project on induced conversions of convertible debt instruments to its technical agenda and directed the EITF to address that project. The focus of the scope of the project, when it was added to the technical agenda, was on clarifying when the induced conversion model should apply rather than on amending or eliminating the existing induced conversion model.

Summary: At its June 15, 2023, meeting, the EITF held an educational session on this Issue. No formal votes were taken, and no decisions were made. The Task Force initially discussed the three issues raised by stakeholders (quoted from the meeting memo):

> (a) **Issue 1 (Conversion With Amended VWAP Terms):** 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? . . .
>
> (b) **Issue 2 (Conversion With Amended Terms for Form of Consideration):** 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? . . .
>
> (c) **Issue 3 (Conversions of Instruments That Are Not Currently Convertible):** Can induced conversion accounting apply to the settlement of a convertible debt instrument that is not currently convertible? [Footnote omitted]

With respect to these issues, the FASB staff indicated its belief that guidance was needed on the "issuance of all of the equity securities issuable"[6] criterion of the induced conversion model. The Task Force discussed two potential high-level approaches identified by the FASB staff to address the accounting for Issues 1 and 2 in relation to this criterion:

- *Preexisting contract approach* — Under this approach, an entity would determine whether it is within the scope of the induced conversion model by considering whether the change made to the conversion provisions terminated the original conversion terms and created new conversion terms. The original conversion terms could include (1) the conversion price and (2) the form of settlement. If the original conversion terms were terminated, the issuer would apply extinguishment accounting.
- *Incremental fair value approach* — Under this approach, an entity would determine whether it is within the scope of the induced conversion model by considering whether the fair value of the consideration transferred under the modified terms is consistent with the originally stated contractual conversion provisions, regardless of the form of settlement. If the modified terms result in a higher fair value than the original terms as of a specified date,[7] the issuer would apply the induced conversion model.

[6] Quoted text is from ASC 470-20-40-13(b).

[7] The point in time (i.e., offer date, acceptance date, or settlement date) at which this measurement will be made will be determined by the EITF as part of this EITF Issue.

During its deliberations, the Task Force identified a few considerations for the FASB staff to research further for discussion at a future EITF decision-making meeting:

- How to account for market repurchases under both approaches.
- How each approach would affect earnings per share.
- How to apply these approaches to scenarios in which an inducement is offered to instruments trading out-of-the-money (i.e., trading at a discount to par).

Effective Date and Transition: The effective date and transition will be discussed at a future meeting.

Next Steps: The FASB staff is expected to continue researching and conducting outreach related to this topic. The Task Force is expected to deliberate the FASB staff's feedback on this issue at its next meeting.

Administrative Matters

The next EITF decision-making meeting is tentatively scheduled for September 14, 2023.

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