

The Impact of ASU 2024-04 on Debt Conversions

Key Aspects of ASU 2024-04:

ASU 2024-04 Debt with Conversions and Other Options (Subtopic 470-20) – clarifies the requirements for induced conversions of convertible debt. Induced settlements can apply when settlements are made in cash or other assets. The inducement offer must preserve the original form and amount of consideration issuable – any additional incentives are recognized as an inducement expense. Induced conversions require that conversions meet three criteria: 1) occur pursuant to conversion privileges that are exercisable only for a limited time; 2) must preserve the consideration (in form and amount) issuable before the inducement offer; and 3) the debt instrument must also have a substantive conversion feature both at the time of issuance and at the offer acceptance date. If a transaction does not meet the three criteria as noted above, the transaction must be accounted for as a debt extinguishment.

Under inducement conversion accounting, a company would recognize expense only for the additional “sweetener” offered to encourage early conversion. With debt extinguishment accounting, a company must recognize a gain or loss for the entire difference between the debt’s carrying value and the total amount of consideration transferred to settle the debt.

If the debt instrument was modified within a year prior to the inducement offer, entities must compare the new terms with those that existed a year earlier or from issuance if the instrument is less than a year old. The fair value of consideration issued less the fair value of what would have been issued under the original terms is the inducement expense.

Situational Example #1 – Induced Conversion

Scenario:

- A company has a convertible debt instrument with a net carrying amount of \$100 and a conversion feature with a current fair value of \$150. The company wants to encourage early conversion to clean up its balance sheet.
- The company offers debt holders an additional \$10 for a limited-time early conversion.

Since the incentive is a limited-time offer and preserves the original consideration (conversion into \$150 worth of equity), it qualifies as an induced conversion.

Accounting:

An inducement expense of \$10 would be recorded on the income statement for the above example. In addition, the debt’s carrying amount of \$100, and the \$150 fair value of the original conversion feature would be reclassified to equity, and no gain or loss would be recorded on this portion of the transaction. The total financial impact would be a pre-tax loss of \$10.

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Situational Example #2 – Debt Conversion

Scenario:

- A company has a convertible debt instrument with a net carrying amount of \$100 and a conversion feature with a current fair value of \$150. The company wants to encourage early conversion to clean up its balance sheet.
- The company offers debt holders a fixed cash payment of \$160 to retire the debt, which is not structured as an induced conversion.

The transaction is a new, separate transaction that substantially changes the original conversion terms. It does not qualify for inducement accounting.

Accounting:

The transaction is treated as a debt extinguishment and a loss on extinguishment would be recorded. The loss is calculated as the difference between the reacquisition price of \$160 and the debt's carrying value of \$100 for a total loss of \$60. The total financial impact would be a pre-tax loss of \$60.

Required Disclosures:

- Nature of the transaction, including a description of the induced conversion and the key terms of the offer.
- An explanation of the accounting policy for induced conversions.
- For entities that adopt the standard retrospectively, the entities should disclose the cumulative effect on retained earnings and the effect on prior-period financial statement items.
- For entities that adopt the standard prospectively, the entities should include a qualitative description of the change in accounting principle.

Summary:

ASU 2024-04 is effective for annual reporting periods beginning after December 15, 2025; however, early adoption is permitted for entities that have already adopted ASU 2020-06 on convertible instruments. The purpose of ASU 2024-04 is to provide clarity and consistency with accounting for convertible debt, as well as whether a conversion should be treated as an induced conversion or a debt extinguishment.