ISDA Safe, Efficient Markets

March 18, 2024

Ms. Hillary Salo
Technical Director
Financial Accounting Standards Board
801 Main Avenue
P.O. Box 5116
Norwalk, CT 06856-5116

By email: director@fasb.org

RE: File Reference No. 2023-ED600, Debt—Debt with Conversion and Other Options (Subtopic 470-20): Induced Conversions of Convertible Debt Instruments, a consensus of the Emerging Issues Task Force

Dear Ms. Salo,

The International Swaps and Derivatives Association's (ISDA)[1] Accounting Policy Committee (the "Committee") appreciates the opportunity to comment and provide our feedback on the Financial Accounting Standards Board's ("FASB" or "Board") Proposed Accounting Standards Update, *Debt—Debt with Conversion and Other Options (Subtopic 470-20): Induced Conversions of Convertible Debt Instruments* (the "Proposed ASU" or "Exposure Draft"). Collectively, the Committee members have substantial professional and practical expertise addressing accounting policy issues related to financial instruments. This letter provides our organization's overall views on the Proposed ASU.

ISDA appreciates your consideration of this topic and thanks you for providing reporting guidelines and clarification for a topic that stakeholders have raised a lot of questions about. ISDA supports the FASB's proposals in the Exposure Draft and believes that the Exposure Draft achieves the Board's objective of improving the application and relevance of the induced conversion guidance to cash convertible debt instruments. The examples and guidance in the Exposure Draft address the issues found in the existing guidance that does not provide guidelines for conversions in which equity securities are not issued upon conversion, but cash is issued instead, either entirely or partially. We have discussed the questions provided by the Board for respondents and provided our feedback below.

Questions for Respondents

<u>*Induced Conversion Assessment*</u>

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.

The Committee agrees with the Board's proposal to require an inducement offer to preserve the consideration (in form and amount) issuable pursuant to the conversion privileges provided in the terms of the debt instrument, but we believe

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additional criteria may need to be considered when determining if a conversion is in scope. While we believe the proposed guidance achieves the Board's objective in most cases to provide clarity, and reduce diversity in practice, for when cash convertible instruments that are settled with terms that differ from the original conversion terms should be accounted for as an extinguishment versus an induced conversion, there are two scenarios we wanted to raise to the Board's attention.

First, relates to the accounting for Instrument C upon conversion. The guidance is focused on same "form" and if an entity settles an instrument fully in shares, this would be accounted for as an extinguishment because the original contractual terms required settlement of the principal in cash. The economics of settling in cash or shares would be the same at the time of conversion, in terms of the value paid by the issuer to convert the debt, but this results in different accounting conclusions. While the Committee does not object to this conclusion, we wanted to raise this to the Boards' attention.

Second, the Committee believes the conversion of an instrument C or instrument X for an amount below par but above parity could misrepresent the economics of the transaction upon conversion. This could occur when the instrument is trading below par and the conversion option is deeply out of the money at the time of the induced conversion. In this scenario, at the time of the inducement, the convertible debt is effectively straight debt as the conversion option is worthless. For example, assume an entity issued convertible debt which has a par value of $1,000, the conversion value is now worthless, and the issuer repurchases the debt at $800 using all cash. An all cash repurchase in this scenario will satisfy the "form and the amount" of the conversion criteria required under the original terms of instrument C or X. Assuming the other criteria in ASC 470-20-40-13 are met, pursuant to ASC 470-20-40-16, this conversion would result in an inducement expense equal to the fair value of all consideration transferred 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. Below are illustrative entries for this conversion:

Dr. Convertible debt	$1,000	
Dr. Expense	$ 800	
Cr. Cash		$ 800
Cr. APIC		$1,000

The Committee believes this accounting misrepresents the economics of the conversion as there is an expense being recognized when debt is converted at terms more beneficial to the issuer. We believe in this scenario, the conversion should be treated as an extinguishment, which would result in a gain being recognized of $200 (par value less cost to convert).

In order to resolve the issue above, the Committee would propose amending ASC 470-20-40-13, by including additional criteria that the conversion feature must be a substantive conversion feature at the time of conversion as illustrated below:

470-20-40-13 The guidance in paragraph 470-20-40-16 applies to conversions of convertible debt instruments pursuant to terms that reflect changes made by the issuer to the conversion privileges provided in the terms of the existing debt instrument (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:

d. <u>The conversion option is a substantive conversion feature at the time the inducement offer is accepted. Refer to ASC 470-20-40-7 through 40-10 for determining whether a conversion feature is substantive.</u>

The Committee believes the change above would further support the Board's objective to provide clarity on determining whether settlement of convertible debt should be treated as an inducement offer or extinguishment, while also providing greater clarity to the users of the financial statements.

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.

The Committee agrees 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. In the case of debt instruments with cash conversion features, as changes in the price of an entity's shares occur over time, the amount of cash or number of shares issued upon conversion can vary based on the date on which the share price is measured. Prior to settlement, it would be unclear whether the form and amount of the consideration received is preserved when an inducement offer uses a future share price for that determination. Thus, we concur that the form and amount of consideration issued under the conversion privileges provided in the terms of the instrument and the inducement offer should be compared using the fair value of the entity's shares at the same point in time.

The Committee agrees that such "same point in time" should be the offer acceptance date because the fair values on that date are typically what would cause this type of transaction to occur and this is also consistent with the current calculation of inducement expense, which is measured as of the inducement offer acceptance date.

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).

Yes, the Committee agrees with the proposal to require a one-year "look back" period preceding the offer acceptance date to assess whether the induced conversion assessment should be made as of (a) the offer acceptance date, or (b) one year before the offer acceptance date – that is, if the debt was exchanged or modified during the one-year period. This guidance is in line with the debt modification guidance in ASC 470-50, which requires entities to consider the terms of a contract prior to any modifications within the previous one-year period in assessing whether the transaction falls under the modification versus extinguishment guidance. The Committee agrees that a look-back provision would avoid entities from being incentivized to modify instruments shortly before inducement to achieve a desired accounting outcome.

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.

The Committee agrees with the proposed amendments to allow an entity to apply the induced conversion accounting guidance to convertible debt instruments that are not currently convertible, given that those instruments contained a substantive conversion feature as of the time they were issued, and they are in scope of the guidance in ASC 470-20.

We agree with the Board's explanation that under existing guidance, an issuer is able to apply induced conversion accounting to a debt instrument with a conversion option that is "out of the money" and is unlikely to be exercised, and this is not significantly different from an instrument with unsatisfied contingencies that prevent the exercisability of the conversion option. In addition, it is common for convertible instruments to not be convertible until very close to their contractual maturity date (e.g., six months in advance) in practice.

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

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The Committee believes that the proposed amendments provide decision-useful information to users of the financial statements and allows stakeholders to understand the value of inducement offers, as they will be recorded as an expense. The proposed amendments are clear in clarifying the requirements for determining whether certain settlements of convertible debt instruments should be accounted for as an induced conversion and further provide useful examples and additional clarifications to aid entities in the application of this proposed guidance.

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?

The Committee agrees with the transition requirement that gives entities the ability to elect to apply the proposed amendments using either a prospective approach or a retrospective approach. We agree that it is not necessary to create a requirement for retrospective application as the benefits of doing so would not outweigh the cost imposed on stakeholders – that is, entities would have to justify the effects of this adoption on already derecognized convertible debt instruments that have no effect on an entity's future cash flows creating an unnecessary burden.

In addition, the Committee agrees with the disclosure requirements directing an entity that elects a retrospective approach to make disclosures that are consistent with those required for entities applying the amendments in ASU 2020-06 using the full retrospective method of adoption, and for those electing a prospective approach, to make disclosures on the nature and reason for the change in accounting principle.

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.

In evaluation of the effective date, the Committee believes that the proposed amendments should be effective for annual and interim periods beginning one year after the publication of the ASU, and no distinction should be made between public business entities and entities other than public business entities. In addition, we believe that early adoption should be permitted in any interim or annual periods in which financial statements have not yet been issued or made available for issuance.

Closing

We hope you find ISDA's comments and responses to the Proposed ASU informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter, please do not hesitate to contact the undersigned.

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