



LETTER OF COMMENT NO. 18

October 15, 2007

Mr. Russell G. Golden
Director of Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: Proposed FASB Staff Position APB 14-a

Dear Mr. Golden:

We appreciate the opportunity to comment on proposed FASB Staff Position APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)" (FSP APB 14-a). Huron Consulting Group has significant experience in advising clients on complex accounting issues, valuation methodologies for convertibles and equity derivatives, and restatement matters, including identifying the causes for the misapplication of GAAP. While we agree the Board should address the accounting for convertible instruments, we do not believe proposed FSP APB 14-a should be issued as a final FASB Staff Position for the following reasons:

- There does not appear to be diversity in practice with the accounting for the instrument within the scope of the proposed FSP (Instrument C of EITF Issue 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion") such that guidance is warranted at this time. We believe the forum for any guidance on separating compound debt instruments should be the Board's Liabilities and Equity project so it is done in a comprehensive way.
- The guidance in the proposed FSP will only add to the unnecessary complexity confronting preparers by introducing a model for allocating the proceeds received on the issuance of a compound financial instrument that we believe will require significant additional effort on the part of preparers in order to comply with the guidance.

If the Board decides to proceed with issuing a final FSP, we believe it should consider the following issues:

- **Scope.** As noted above, we assume that the proposed FSP only provides guidance on the accounting for Instrument C of Issue 90-19. If that is the case, we believe the discussion in paragraph 5 should be revised to indicate that the FSP applies to

convertible debt instruments that require (as opposed to permit) settlement of the accreted amount in cash.

- **Potential unintended consequences.** We are concerned that the proposed guidance could have unintended consequences and believe a final FSP should make preparers aware of those consequences. For example, if a company issues a convertible debt instrument that is puttable in the event of a change of control (a common provision in most debt instruments), the guidance in Statement 133 Implementation Issue No. B16, “Embedded Derivatives: Calls and Puts in Debt Instruments,” would likely require the company to separate that common put feature from the host debt instrument and account for the put as a derivative.
- **Transition and Effective Date.** We believe the proposed guidance should not be applied on a retrospective basis because of the issues identified above, in particular the potential need to identify and separate any embedded derivatives (i.e., contingently exercisable put options) that would not be clearly and closely related to the debt host contract. We would prefer a transition method similar to the method used in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, for embedded derivatives.

We expand on each of our concerns below.

Need For Guidance

We do not understand the Board’s reasons for issuing the proposed guidance. We are unaware of any significant diversity in practice in accounting for debt instruments within the scope of the proposed FSP or a lack of understanding of the accounting by investors that would warrant additional guidance. Additionally, the proposed FSP does not make a case for there being diversity in practice. Further, we are confused by the reasons stated in proposed FSP APB 14-a. If, as stated in paragraph B3 of the Basis for Conclusions, the guidance in Issue 90-19 inappropriately expanded the application of the guidance in paragraph 14 of Opinion 14, we do not understand why the Board waited until now to take action. Finally, any question over whether the accounting required by Issue 90-19 reflects the economics of convertible debt instruments would not seem limited to only Instrument C since all convertible debt has similar economics (i.e., a reduced interest rate and a feature that derives its value from increases in the issuer’s stock price). Given that the economics of Instrument C do not appear to be significantly different from any other convertible security, we believe the Board’s project on Liabilities and Equity is the most appropriate means to address this issue.

We believe there are better uses of the Board’s resources than providing guidance on an area where there does not appear to be diversity in practice. For example, we note that the Board has declined to provide guidance (or allow the EITF to provide guidance) on the following issues because of the Liabilities and Equity project:

- EITF Issue No. 00-27, “Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios.”

- EITF Issue No. 02-D, “The Effect of Dual-Indexation both to a Company’s Own Stock and to Interest Rates and the Company’s Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.”
- EITF Issue No. 02-2, “When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes.”

We would prefer that the Board (or EITF) provide guidance on those issues rather than changing guidance that is clear.

We believe the issues addressed in the proposed FSP are clearly within the scope of the Liabilities and Equity project and question why the Board does not wait until it has completed its work on Phase II of that project. The January 30, 2004 FASB Report, in discussing the issuance of a statement that would incorporate changes in the conceptual framework definition of liabilities and equity, noted that the Board would consider whether to classify those instruments entirely as equity, as liabilities (or assets), or between liabilities and equity, or “instead to analyze those instruments into components to be classified separately based on their characteristics.” Accordingly, we believe the Board should address the accounting for all convertible instruments at the same time.

Complexity

The proposed FSP requires an issuer to allocate the proceeds from issuing those instruments within its scope first to the debt component in an amount equal to the fair value of a nonconvertible debt instrument, with the remainder allocated to the conversion feature. Paragraph B8 of proposed FSP APB 14-a states:

The inputs required to estimate the fair value of a nonconvertible debt instrument ... are expected to be available with limited effort for issuers of instruments within the scope of this FSP. Many of those entities currently have nonconvertible debt instruments outstanding for which the fair values are disclosed in accordance with FASB Statement No. 107

As stated previously, we do not agree with the Board’s presumption and question the basis for the conclusion that the information will be readily available. While there are companies with nonconvertible debt outstanding, we do not necessarily agree that the terms of that debt will provide a basis to estimate the fair value of the debt component of the convertible instrument without adjustments for differences in terms. This issue was considered by the Accounting Principles Board in its consideration of Opinion 14. As noted in paragraph 8 of Opinion 14:

Furthermore, issuers often claim that a subjective valuation of a debt security without the conversion option but with identical other terms (which are usually less restrictive on the issuer and less protective of the holder than those of nonconvertible debt) is difficult because such a security could not be sold at a price which the issuer would regard as producing an acceptable cost of financing.

Thus, when the attractiveness to investors of a convertible debt security rests largely on the anticipated increased value of the issuer's stock, the conversion feature may be of primary importance, with the debt feature regarded more as a hedge than as the principal investment objective.

Companies will be required to consider the effect on fair value of differences such as seniority, collateral, term, events of default, put features, and other terms. Because there will be no clear evidence of the impact of differences in those terms on fair value, companies will be required to estimate the effect of such differences, which we believe will be a more complex undertaking than the FSP contemplates.

Further, although the method of allocating proceeds prescribed in proposed FSP APB 14-a is consistent with the method in IAS 32, *Financial Instruments: Disclosure and Presentation*, it will result in a third method (at least) for allocating proceeds from the issuance of a debt instrument under US GAAP (joining the relative fair value method required by APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, and the method required by Statement 133 for allocating full fair value to an embedded derivative that is required to be accounted for separately from the host contract). If the Board decides to issue a final FSP, we would prefer it adopt either of the existing methods for allocating proceeds. Those methods are generally well understood in practice and will be easier to implement than the method reflected in the proposed FSP.

Because of our concerns over the ability of companies to estimate the fair value of the debt component of the convertible debt instrument, we would prefer a method that allocates proceeds first to the fair value of the conversion option, with the remainder being allocated to the debt component. We believe this method could be implemented at less cost than the method proposed in the draft FSP as most companies have experience with determining the fair value of equity derivatives. Many companies enter into equity derivatives designed to hedge the dilutive impact of a conversion feature and therefore will have information relevant to the fair value of the conversion feature.

Scope

The example included in paragraph A1 of proposed FSP APB 14-a states, in part:

Upon conversion, Company A can elect to settle the entire if-converted value (that is, the principal amount of the debt plus the conversion spread) in cash, common stock, or any combination thereof.

That description is consistent with the description of Instrument B from Issue 90-19. As issuers are already required to account for Instrument B as convertible debt for purposes of computing fully diluted earnings per share, we were not certain whether the guidance in the proposed FSP was intended to change the accounting for those instruments. If our assumption is correct, we would suggest changing the facts in the example (as well as in paragraph 5) to conform to the description of Instrument C in Issue 90-19.

Possible Unintended Consequences

If the Board issues the proposed guidance as a final FSP, we believe it should provide guidance on whether Statement 133 Implementation Issue B16 applies to the debt instrument once the issuance proceeds have been allocated. If that guidance does apply and if the debt instrument includes a contingently exercisable put, we believe the issuer would be required to account for the contingently exercisable put separately from the debt instrument. If our analysis is correct, we believe the final FSP should include a reference to the provisions of Statement 133 Implementation Issue B16 so that preparers who may not have focused on this issue receive adequate warning. Further, requiring companies to separate a contingently exercisable put and determine its fair value for all prior periods only increases the unnecessary complexity of the proposed guidance.

Transition and Effective Date

We do not believe companies will have sufficient time to implement the guidance in the proposed FSP, primarily because we don't agree with the Board's presumption that the information is readily available, but also because of the potential interaction with Statement 133 Implementation Issue B16 and the fact that many debt instruments include contingently exercisable put provisions.

We believe the burden on preparers would be significantly lessened (and the Board's preferred effective date would be achievable) if the Board adopted a transition provision similar to the one it provided in Statement 133. Accordingly, we would encourage the Board to select a recent date in 2007 and require application of the proposed guidance only to instruments issued after that date.

Other Comments

While we agree a modification of a debt instrument requires the issuer to conclude if the modification should be treated as an extinguishment, that determination is required whether or not the modified instrument is within the scope of the FSP. Presumably, an issuer would apply the accounting described in paragraph 18 whether it concluded the modification was an extinguishment or not. If so, we don't believe the guidance in that paragraph is necessary. However, if the Board or the staff believes some other result is possible, we recommend the Board explain that result more clearly.

In addition, we believe the Board should explain why the issuer should not apply the guidance in FASB Technical Bulletin No. 85-6, *Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt*, to determine the appropriate accounting if the consideration allocated to the reacquisition of the conversion feature exceeds the fair value of that feature.

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We would be pleased to discuss our comments with the Board or the FASB staff. Please direct your questions or comments to Jeff Ellis at (312) 880-3019 or Ken Evola at (202) 585-6860.

Sincerely,

/s/ Jeffrey H. Ellis

Jeffrey H. Ellis
Managing Director

/s/ Kenneth J. Evola

Kenneth J. Evola
Managing Director