



October 18, 2007

Russell G. Golden, CPA
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: August 31, 2007 FASB Proposed FSP APB 14-a, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (File Reference: Proposed FSP APB 14-a)

Dear Mr. Golden:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the Proposed FSP and is providing the following comments for your consideration.

GENERAL COMMENTS

TIC believes the separation methodology for convertible debt instruments outlined in the proposed FSP is logical and appropriately reflects the economic substance of these transactions. The guidance is also timely as certain TIC members are seeing more of these transactions in their practices. The Committee's remaining comments request clarifications as to scope and measurement and a change from retrospective to prospective transition, as outlined below.





SPECIFIC COMMENTS

Scope Question

TIC questioned whether the scope of the Proposed FSP would include a convertible debt instrument that must be physically settled in stock upon conversion if the underlying shares themselves are redeemable. TIC is concerned that convertible debt instruments with such features could be structured to account for the conversion feature as an equity instrument, as provided in the Proposed FSP. TIC believes a convertible debt instrument with such features would be outside of the scope of the Proposed FSP and should be accounted for as a liability in the spirit of FSP FAS 150-5, *Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable*. (TIC recognizes, however, that FSP FAS 150-5 generally applies to freestanding financial instruments only.) TIC requests that guidance be included in the final FSP to address the accounting for this type of instrument to avoid possible future implementation issues.

Measurement Issues

Measurement Issue 1

Contrary to the assumption in paragraph B7 of the proposal, TIC believes it may be more difficult to determine the fair value of a comparable debt instrument without a conversion feature than to apply other bifurcation methodologies. Paragraph B8 assumes that the fair value of a comparable debt instrument would be readily available for many issuers within the scope of this proposed FSP because they would have already issued other instruments without the embedded conversion option that would provide the necessary information about market interest rates and the issuer's credit standing. In fact, there are issuers that have not issued other debt instruments. As such, these issuers would need to find other comparable debt instruments outside of their entities in order to find a market rate for similar notes that have no conversion rights.

Therefore, estimating the fair value of a comparable debt instrument will be at least as difficult (and require as much judgment) as estimating the fair value of the liability component of the convertible debt instrument. TIC members believe that it may be easier to determine a fair value for the embedded derivative instead, and use this for purposes of recording a discount on the Instrument C. TIC recommends that the FSP permit two methods to measure the discount—either a discount based on the interest rate of a comparable debt instrument without the conversion feature (if the issuer has issued such an instrument) or a discount based on the fair value of the embedded conversion feature as is done with other embedded derivatives which require bifurcation from the host contract.





Measurement Issue 2

As indicated above, certain TIC members find that convertible debt instruments with multiple components are becoming more common in private equity deals with venture capitalists and in companies that anticipate going public. Not uncommonly, convertible debt may be issued with a beneficial conversion feature, attached warrants and embedded derivatives combined in one instrument.

The proposal is unclear regarding the measurement sequence for complex instruments. Specifically, the last two sentences of paragraph 11 seem to contradict each other. The second sentence of paragraph 11 says to identify any embedded features (other than the conversion option) within the convertible debt instrument and determine if any of those features must be accounted for separately as a derivative instrument under FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities*. This implies that the fair value of the Statement 133 derivative would be determined first and deducted from the proceeds received, with the remainder accounted for in accordance with the separation method in the proposed FSP.

However, the third sentence of paragraph 11 implies that the debt component combined with the Statement 133 derivative would be valued together first, with the residual applied to the conversion feature, then bifurcating the debt and derivative. If the intended accounting is to carve out the Statement 133 derivative first, TIC suggests the third sentence of paragraph 11 be modified as follows:

*If an embedded feature (other than the embedded conversion option) is required to be separately accounted for as a derivative, it shall be separated from the **other provisions of the instrument** in accordance with the guidance in Statement 133 and its related interpretations. [Emphasis added]*

TIC requests that additional guidance be provided with an accompanying example to clarify the appropriate measurement approach in these cases.

Transition Issue

TIC is concerned that the requirement for retrospective application of the standard upon adoption will create an implementation burden for preparers that would not be justified in the private company environment. This transition provision seems especially harsh and punitive given the fact that the final FSP is contrary to the existing EITF issues, which do not require bifurcation of the debt or a fair value approach. TIC also questions the





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cost/benefit of retrospective application for users and preparers of private company financial statements. The cumulative effect of adopting the FSP would be an esoteric, noncash charge that would have little meaning or relevance for most private company lenders.

For these reasons, TIC recommends that the final FSP be applicable to new and modified instruments only. Precedent for this transition was established in FASB Statement No. 123(R), *Share-Based Payment*, for nonpublic entities that used the minimum value method in Statement No. 123, *Accounting for Stock-Based Compensation*.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Edward J. Knauf, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees

