



Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

File Reference: FSP APB 14-A

October 10, 2007

Dear Sirs/Mesdames:

Thank you for the opportunity to offer our views on FSP APB 14-A, *Accounting for Convertible Instruments that May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (the FSP). In reading our response, please be aware that we refer herein to the instruments covered by the FSP as either *Instrument C* (whose principal must be settled in cash) or as *Instrument X* (whose principal can be settled in cash or shares), and collectively as *Instrument C/X*. As noted in our March 8, 2007 letter (the March Letter) to you on proposed EITF 07-2, we disagree with the guidance in the FSP. We recognize that the current accounting model does not perfectly capture all dimensions of convertibles; however, the current framework is well understood by the market, and—compared to the proposed changes—is both easier and less confusing to readers of financial statements. Please find repeated below four pertinent assertions from our March Letter (with the roman numerals in brackets cross-referencing that letter, attached as the Appendix to this correspondence), but we advise you to consult the March Letter in its entirety for our complete opinion:

- (I) **Instrument C/X is not economically equivalent to debt plus warrants. [Item II]**
- (II) **Treating an Instrument C/X as debt plus warrants distorts financial statements. [Item III]**
- (III) **Asserting that Instruments C/X are outside APB 14's scope is not correct per our read of APB 14; we contend the FSP should be as a formal amendment of APB 14. [Item IV]**
- (IV) **Prohibiting grandfathering is inconsistent with the well-established practice of relying on DIG Issue K5 when changing the accounting for derivatives. [Item V]**

In addition to the foregoing four items, we now have three additional observations.

- (V) **The transition provisions obfuscate the financial statements of issuers of Instrument X convertibles that applied the if-converted method for all prior periods.**

- (VI) You provide an unworkable model for establishing the debt discount that must be calculated upon bifurcating Instrument C/X.
- (VII) The EPS guidance needs to be prominent in the *Standards Section* of the FSP and FAS 128R must reference by paragraph number this revised FSP EPS guidance.

V. The transition provisions obfuscate the financial statements of issuers of Instrument X convertibles that applied the if-converted method for all prior periods.

We understand that retrospective application is required per FAS 154 for such changes in accounting principles as addressed by the FSP; however, we believe the Board should make an exception for those issues of Instrument X convertibles who have applied the if-converted method for all prior periods. These issuers primarily employed Instrument X technology to obtain flexibility regarding share dilution upon conversion, and their investors are not better served by retrospective application since their financial statements already reflect the EPS effects of a *Conventional Convertible*. This situation is especially true for those issuers *not* planning to change their Instrument X convertibles to Instrument C convertibles as part of their adoption of FAS 128R, because it will then be clear that these issuers never desired the *Modified If-Converted Method* EPS treatment described in EITF 90-19 for Instrument C.

To require these Instrument X issuers to bifurcate is to create three EPS classes for convertibles: (1) Conventional Convertibles, subject to the If-Converted Method; (2) what we will call Instrument C/X Treasury Stock Convertibles, subject to the Modified If-Converted Method (keep coupon and phantom interest in the numerator, add net shares to the denominator); and (3) Instrument X If-Converted convertibles, subject to higher interest expense in Basic EPS, and then the same If-Converted dilution as a Conventional Convertible. However, for these Instrument X If-Converted issuers, Basic EPS could be more dilutive than application of the If-Converted Method for diluted EPS.

We urge the Board to provide a narrow transition exception for companies who issued Instrument X convertibles but applied the if-converted method (if dilutive) for all periods presented since issuance. Of course, this guidance should note that if the instrument is modified to become an Instrument C convertible, retrospective bifurcation from issuance would be required. Moreover, the transition provision should require retrospective application of bifurcation to issuance date if, prior to the adoption of FAS 128R, the issuer represents that it will cash-settle the principal (and has the financial wherewithal to do so) and moves to the Modified If-Converted Method. The Board should be

comfortable with this proposed narrow transition provision, because the implementation of FAS 128R for fiscal periods beginning after 12/15/08 means any unmodified Instrument X convertibles will thenceforth be bound by the if-converted method.

In summary, we strongly advocate that the Board abandon its unreasonable position with regard to Instrument X issuers who have always employed the If-Converted Method: The proposed transition is not only punitive to these issuers but also confuses the users of their financial statements, who are unlikely to understand that their company is subject to a third EPS model regarding dilution calculation. Users of these obfuscated financial statements will not benefit from this obscure distinction and the needless complexities of having three methods of calculating dilution for convertible bonds.

VI. You provide an unworkable model for establishing the debt discount that must be calculated upon bifurcating Instrument C/X.

We are in agreement with our advisors as to the practical difficulties involved with the *Expected Maturity Model* (or the Model) proposed in the draft FSP. We understand that these advisors provided you with their reasoning in their "fatal flaw" letters submitted to you. Consequently, we shall not repeat these concerns; rather, we would simply like to remind you that if large accounting firms are saying the Expected Maturity Model is unworkable, we are almost certain that the thousands of smaller auditing firms¹ will have difficulty implementing this Model in a manner that results in comparable financial statements. These local accounting firms increasingly audit public companies, and your guidance will create huge diversity in practice as well as what in many circumstances upon examination (if that ever occurs) will be determined not to be appropriate accounting, even within the wide bands allowed by the Expected Maturity Model.

We see no reason for the Board to create this hugely difficult practice problem. Instead, we recommend that the Board comprehensively address (1) the amortization period for *all* debt premiums, and (2) the accretion periods for *all* debt discounts and deferred issuance costs. Such a project would

¹ We routinely work with smaller accounting firms as part of our capital markets due diligence process.

have the added benefit of eliminating current diversity in practice that exists today in nonconvertible instruments. We propose that the Board develop the following relatively simple, practicable model:

Debt Premiums—All Debt

- Amortize to contractual maturity, regardless of the existence of any puts or calls.

Debt Discounts and Deferred Issuance Costs—All Nonputtable Debt

- Accrete to contractual maturity; ignoring any calls.
 - This will help eliminate significant diversity of practice, with some auditors currently insisting that these items be accreted to the first call date, while others currently prohibit the same, and others still leave it as an accounting policy choice.

Debt Discounts and Deferred Issuance Costs—All Puttable Debt other than Instruments C/X

- Accrete to first put date (ignoring any calls).

Debt Discounts and Deferred Issuance Costs—Puttable Instruments C/X at issuance

- If an Instrument C/X, calculate the FSP APB 14-A debt discount based on issuer's nonconvertible debt's effective yield to either its contractual maturity or the first put (ignoring any calls) date if shorter, and then accrete to this date, with the following additional guidance:
 - If the first put date is met and the debt has not been put or converted, recalculate a new debt discount as discussed below.

Debt Discounts—Puttable Instrument C/X Convertible Debt if not redeemed/converted by a put date

- American Put: Calculate a new debt discount based on the debt's effective yield to its contractual maturity (ignoring any calls), and then accrete to this date.
- European Puts: Calculate a new debt discount based on the debt's effective yield to the next put date (ignoring any calls), or if none, contractual maturity. If the next put date is met and the debt has not been put or converted, repeat this process (ignoring any calls) if more European put dates still exist in the future or to contractual maturity, if no more put dates.

The Board can accomplish this straightforward guidance by publishing a short statement that could be entitled, *Accounting for Debt Issuance Discounts, Deferred Issuance Costs, and Premiums*. The FSP can then reference that statement and eliminate not only the unworkable guidance regarding the

expected maturity of the debt host contract absent the conversion warrant but also the wide diversity that currently exists in practice for these fundamental element of debt issuances irrespective of convertibles.

VII. The EPS guidance needs to be prominent in the Standards Section of the FSP and FAS 128R must reference by paragraph number this revised FSP EPS guidance.

We are troubled by the Board's treatment of the EPS guidance for Instrument C². It is not realistic to expect practitioners to read the *Basis For Conclusions* section of this FSP. The Board needs to have an EPS discussion in the *Standards Section* (i.e., the section that does not have a letter preceding its paragraph numbers) of the FSP. In that discussion, the Board needs to provide a label for the calculation method (which we have referred to as the Modified If-Converted Method, as discussed above), to contrast it from both the If-Converted Method and the FAS 128R-newly-defined *Treasury Stock Method*. Finally, the Board needs to define this method in this section by repeating the guidance currently found in EITF 90-19 with regard to Instrument C.

If the FSP is issued as presently composed, without this labeled EPS guidance in the Standards Section of the FSP, we expect a huge diversity in practice to occur upon the issuance of FAS 128R³. As both the FSP and FAS 128R are currently drafted, the combination of (1) complete silence in FAS 128R regarding Instrument C, with (2) a radical reworking of the *Treasury Stock Method*, and (3) the absence of an EPS discussion in the Standards Section of the FSP, means that many accounting firms will assume they need to apply the new FAS 128R *Treasury Stock Method* to Instrument C, commonly referred to as a *Treasury Stock Convertible*⁴. Our experience suggests that these practitioners will not read the Basis of Conclusion to understand that a different method from the *Treasury Stock Method* exists for calculating dilution for Instrument C convertibles. Moreover, even if a practitioner should

² Use of this term by us henceforth includes those Instrument X convertibles whose issuer has represented cash settlement and has the demonstrated financial wherewithal, which results in Instrument C accounting prior to the adoption of FAS 128R.

³ We were privileged to review the "fatal flaw" version of FAS 128R.

⁴ We believe *Treasury Stock Convertibles* will remain in the marketplace subsequent to both this FSP and FAS 128R

find the Basis for Conclusions reference to obscure EITF Issue 04-8, how often will that firm have the amended version of EITF 04-8?

Absent the foregoing recommended changes to both the FSP and FAS 128R, we will not be surprised if the correct application of GAAP for calculating Instrument C dilution occurs only in the breach (i.e., after being questioned by the SEC). In contrast, the preparers of financial statements either filed without SEC review or prepared for private companies will likely have their clients employ the new Treasury Stock Method, resulting in an incorrect application of GAAP, which will be especially erroneous when parity value is greater than the bifurcated debt's carrying value, with dilution reported under this approach.

In addition to the foregoing changes to the Standards Section of the FSP, the Board should also (1) move the example proposed for the amended version of EITF 04-8 to Appendix A of the FSP, and (2) include a specific reference to the FSP in FAS 128R when discussing the If-Converted Method in that standard. Guidance on this complex accounting issue will then be clear.

Thank you again for permitting us to comment on the FSP.

Very truly yours,



Mark De Rocco
Managing Director
Strategic Finance

cc: Paul. Rosica
Senior Managing Director
Equity Linked Capital Markets

Robert Aberman
Senior Managing Director
Equity Linked Capital Markets

[REDACTED]

**Appendix – Bear Stearns’ March 8, 2007 Letter to FASB re
Proposed EITF 07-2**

Dear Mr. Smith:

We would like to comment and offer our views on the Agenda Summary of EITF 07-2, “Accounting for Convertible Instruments that Require or Permit Partial Cash Settlements upon Conversion”. We support View A with regard to these types of convertible instruments, which we shall refer to as “Instrument C/X” (or separately as either Instrument C or Instrument X, as the discussion warrants). Our response addresses the following six key issues:

- (I) **As a procedural matter, this issue should not be addressed by the EITF.**
- (II) **Instrument C/X is not economically equivalent to debt plus warrants.**
- (III) **Treating an Instrument C/X as debt plus warrants distorts financial statements.**
- (IV) **View B is an inaccurate application of APB 14.**
- (V) **Prohibiting grandfathering is inconsistent with the well-established practice of relying on DIG Issue K5 when changing the accounting for derivatives.**
- (VI) **Assuming adoption of View B, the EITF needs to address the FAS 109 treatment of the bifurcated debt.**

I. As a procedural matter, this issue should not be addressed by the EITF.

The charge of the Emerging Issue Task Force (EITF) is to interpret existing GAAP where uncertainty or diversity in practice exists. This is not the situation for Instrument C/X. In 2002, The EITF clearly laid out the accounting for Instrument C in its revised guidance to EITF 90-19, and the SEC confirmed this guidance in a speech at the 2003 AICPA SEC conference. Accordingly, there is no uncertain or diverse practice to resolve through an EITF issue.

II. Instrument C/X is not economically equivalent to debt plus warrants.

An investor who owns debt plus warrants can pursue his equity stake while at the same time retain his creditor status with regard to principal. This is not the same for Instrument C/X. Upon conversion, an investor relinquishes his creditor claim and, assuming no sudden bankruptcy on the part of the issuer, receives his conversion value either wholly in cash (if conversion value is less than par value) or in part cash (equal to par value and issuer shares (equal to “Conversion Spread). Conversion does not preserve creditor claims, and it is possible upon a conversion, even one at maturity, to receive less than par value because the stock drops during the averaging period if the common “Look Forward” methodology is employed. (See table in Appendix for an illustration of this situation.)

III. Treating an Instrument C/X as Debt plus Warrants Distorts Financial Statements.

Under View B, investors would neither have an accurate view of balance sheet leverage nor of cash interest expense. These distortions could force investors to focus on non-GAAP cash metrics for value, thereby detracting from the value of GAAP financial statements.

IV. View B is not an accurate application of APB 14.

View B quotes (via added emphasis) passages from ¶¶7, 12, and 18 of APB 14 in support of its position. Each one of these emphasized quotes can be refuted as providing support for View B:

¶7: “Furthermore the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he forgoes the right to redemption, and vice versa.”

As noted above, receiving cash for an amount less than or equal to par value upon conversion is not a redemption event because the investor has foregone his creditor rights the moment he elects to convert. The fact that some of the conversion consideration is paid in cash actually can increase the investor's equity exposure, because he is exposed to equity price risk during the averaging period. Mutual exclusivity of the conversion option vs. redemption of the debt host remains a hallmark of Instrument C/X, just as it is a defining feature of “conventional convertible debt” (as the term is used in ¶4 of EITF 00-19).

¶12: “In reaching this conclusion, the Board places greater weight on the inseparability of the debt and the conversion option (as described in paragraph 7) and less weight on practical difficulties.”

The debt and conversion option component of Instrument C/X remains inseparable during its life and upon conversion or redemption. Consistent with ¶7, if an investor redeems an Instrument C/X early (for example, through a put right), he has irrevocably lost his conversion option, no matter how high the stock rises during the contractual life of the instrument. If the investor had debt plus warrants, he could have held on to the warrants while redeeming the debt, a situation that is not possible with Instrument C/X.

¶18: “Securities not explicitly discussed in this Opinion should be dealt with in accordance with the substance of the transaction.”

The substance of Instrument C/X is that of APB 14 convertible debt, as has been affirmed by EITFs 90-19, 00-19 (in its ¶4 discussion of “nonconventional convertibles”) and 03-7, as well as the market, which is indifferent as to whether some of the conversion consideration is paid in cash or in shares.

Accordingly, when the three APB 14 paragraphs are analyzed, they are found not to support a change in accounting treatment of Instrument C/X. Rather, these paragraphs are meant to address instruments that are truly economically different from convertible debt.

V. Prohibiting grandfathering is inconsistent with the well-established practice of relying on DIG Issue K5 when changing the accounting for derivatives.

The Board recently completed a difficult project addressing the “shortcut method” as applied to interest rate swaps. As part of its clarified accounting guidance, the Board is specifically relying on DIG Issue K5 for transitioning those entities not previously following the Board's clarified guidance. We believe that K5 should also be applied to a new requirement to bifurcate convertible instruments. While the FASB Staff indicates that grandfathering is not acceptable for comparability purposes, the Board and

Staff have previously recognized that the benefit of relieving the process burden related to bifurcation can outweigh any comparability benefit. Should the EITF accept the specious reasoning that APB 14 supports the accounting of View B; we believe the same cost-benefit analysis that went into K5 with regard to bifurcating derivatives also applies here. The Board explicitly accepted this trade-off in DIG Issue K5 related to bifurcable embedded derivatives upon adoption of FAS 133, and we are troubled by the Board not applying the same rationale to any new bifurcation requirement with regard to Instrument C/X. We believe it sets a bad precedent for the Board not to follow its own guidance with regard to new accounting for derivatives, whether embedded or freestanding and whether 00-19-compliant or FAS 133 derivatives, as comprehensively memorialized in DIG Issue K5. The Board and Staff should pause to consider whether such inconsistent application of clearly delineated policy is in the Board's best interest, as it suggests that the Board is willing to abandon its own policies if sufficiently pressured.

VI. Assuming adoption of View B, the EITF needs to address the FAS 109 treatment of the bifurcated debt.

EITF 05-8 states that bifurcating debt for a beneficial conversion feature creates a FAS 109 basis difference for which deferred taxes must be provided. We expect that the same guidance would apply to any Instrument C/X that is bifurcated pursuant to View B. We also believe that this issue is not well understood by the market or practitioners and if the EITF were to agree to View B, it behooves the Task Force to address the FAS 109 treatment of the resulting basis difference. Accordingly, the FASB Staff, who we understand is preparing and updating the Issue Summary, should immediately incorporate the FAS 109 entries into ¶¶B3-4, B6, and B9-12 of the Agenda Summary of EITF 07-2. The integration of the EITF 05-8-consistent accounting will save both the EITF and the FASB a great deal of future work, as it will eliminate the diversity in practice that will inevitably arise as some practitioners insist that EITF 05-8 should not be applied to View B accounting. If for some reason, the EITF and the Board do not believe that EITF 05-8 should be applied to EITF 07-2, then this issue needs to be fully discussed at a meeting to establish the reasons why View B results in a different FAS 109 treatment from Issue 05-8, and a new Issue Summary would need to be circulated before any decision could properly be made by the Task Force.

Summary Recommendation

We urge the Board to return this issue to the accelerated "modified joint" Liabilities & Equity project. In this forum, with the availability of full due diligence, it can be properly vetted.

Thank you again for the opportunity to comment on this issue.

Appendix

Look Forward Methodology of Determining Conversion Value

Instrument C/X

Par	\$1,000.00
Stock Price at Issuance	20.00
Conversion Price at Exercise	25.00
Premium	25%
Conversion Rate	40.0000

Day	Daily VWAP	Daily Conversion Value	Cash Portion	Shares
1	\$26.50	\$42.40	\$40.00	0.0906
2	26.00	41.60	40.00	0.0615
3	25.50	40.80	40.00	0.0314
4	24.75	39.60	39.60	0.0000
5	24.25	38.80	38.80	0.0000
6	24.50	39.20	39.20	0.0000
7	24.00	38.40	38.40	0.0000
8	23.00	36.80	36.80	0.0000
9	22.50	36.00	36.00	0.0000
10	22.00	35.20	35.20	0.0000
11	20.50	32.80	32.80	0.0000
12	20.00	32.00	32.00	0.0000
13	20.05	32.08	32.08	0.0000
14	20.50	32.80	32.80	0.0000
15	21.00	33.60	33.60	0.0000
16	21.25	34.00	34.00	0.0000
17	21.38	34.21	34.21	0.0000
18	21.50	34.40	34.40	0.0000
19	21.26	34.02	34.02	0.0000
20	21.18	33.89	33.89	0.0000
21	21.75	34.80	34.80	0.0000
22	22.00	35.20	35.20	0.0000
23	22.50	36.00	36.00	0.0000
24	22.38	35.80	35.80	0.0000
25	23.00	36.80	36.80	0.0000

Cash	\$896.39	
Shares		0.1835
\$ Value of Shares		\$4.22

Total Value \$400.61