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FSPAPB14-A

LETTER OF COMMENT NO. 31

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Financial Accounting Standards Board
401 Merritt 7
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Proposed FASB Staff Position No. APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)"

Dear Mr. Golden:

We appreciate the opportunity to comment on proposed FASB Staff Position No. APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)". We believe the current accounting for convertible debt, including cash settled convertible debt (such as "Instrument C"), does not accurately reflect the underlying economics of such arrangements. We support the issuance of guidance in this area because we believe separating such instruments into their debt and equity components produces an accounting result more consistent with their underlying economics. However, we recommend extending the scope of this effort to address all convertible instruments, whether cash settled or not.

The accounting for convertible instruments has become complicated to the point where it lacks any consistent meaning for financial statement users. Further, we believe most of this complexity stems from piecemeal efforts to address issues related to the recognition of financing costs paid in the form of embedded written call options on the issuers' stock. We support the Board's guidance in the proposed FSP because it represents a step in the right direction. However, we believe this process of continuing to address accounting issues related to convertible debt on an instrument-by-instrument basis is not effective, leads to inconsistencies in accounting for similar instruments, and adds unnecessary complexity to the accounting standards. Accordingly, we believe an overall reconsideration of the basic principles regarding convertible debt in APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants* for all convertible instruments, not just partially cash settled instruments, is needed. We believe this effort can and should be conducted in a timely manner as a separate technical project prior to completing the Liabilities and Equity Project.

Further, whether the scope of the guidance is expanded or not, we believe certain changes are necessary to the guidance on measuring and accreting the debt component of affected convertible instruments to ensure application consistent with the Board's objectives. These comments and others are discussed in more detail below.

Scope of Proposed Guidance

The current approach where conversion features are separated from debt instruments in some, but not all, situations is overly complex and may create significant differences in reported results that are not justified by differences in the arrangements. The accounting model in APB 14 that allows an issuer of convertible instruments to disregard the fair value of a valuable written call option when accounting for the instrument and the inconsistent interpretations related to that model have resulted in the "Instrument C" phenomenon discussed in the proposed FSP as well as other arrangements. Although we support the proposed conclusion that the liability and equity components of convertible debt instruments that may be settled in cash should be accounted for separately, we believe that conclusion is appropriate for other convertible instruments as well. We are also concerned that the narrow scope of the proposed FSP will ultimately result in the need for additional standard-setting on future instruments, further complicating an already complex area of the accounting literature.

Therefore, we recommend expanding the scope of the Board's project to:

a) Address all convertible debt and convertible preferred stock for which the embedded conversion feature is not accounted for as a derivative under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*,

b) Develop a more consistent model for accounting for all separated conversion features, which would include replacing EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" and EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments". For example, a fair value model for separation of all conversion features could simplify the current situation where different models are used in different circumstances.

In order to expand the scope in this manner, we believe the Board would need to re-expose the proposal as a more fundamental amendment to APB 14. Nevertheless, we believe the benefits of expanding the scope outweigh the cost of the additional time required to affect a more far reaching amendment. Those benefits include a more consistent accounting treatment for all convertible instruments, bringing U.S. GAAP closer to IFRS, the elimination of the beneficial conversion feature model (a very complicated series of rules that are difficult to apply and often produce results not readily aligned with the economics of the arrangement), and an increased likelihood that additional standard-setting will not be necessary in an area that already has too many rules. We believe issues related to convertible debt have become significant enough to warrant separate consideration prior to completion of the Board's Liabilities and Equity Project, particularly considering the likely timing of any final standard from that project.

Model for Separation

We believe the Board should consider an approach whereby the fair value of the conversion option is allocated to the conversion component of the instrument with the residual proceeds applied to the debt component. That model is consistent with the model for accounting for embedded derivatives under FASB Statement No. 133 and should also yield a result consistent with the objective of recognizing a market rate of interest on the debt component. While we believe the level of valuation complexity associated with that model is no more or less difficult than valuing the debt component and applying the residual to the equity component (after considering the difficulties with that model discussed further below), a model that focuses on determining the fair value of the embedded option has the advantage of being consistent with existing literature.

However, if the Board continues with the approach in the proposed FSP, modification of the guidance for separating convertible instruments into their debt and equity components is needed in order to ensure the model will be applied in a consistent manner so that it can be interpreted in a meaningful way by users. Those modifications would also impact subsequent measurement of the debt component.

The objective of the Board's model is articulated in paragraph 9 of the proposed FSP as a separation and measurement approach that produces an income statement that "will reflect the entity's nonconvertible borrowing rate when interest cost is recognized in subsequent periods". However, the more detailed guidance in paragraphs 10 and 14 requires the issuer to implement this objective by valuing and determining the expected life of a hypothetical debt instrument that does not include the conversion feature. Because this approach requires the issuer to value a hypothetical instrument, we believe it could produce unintuitive results relative to the actual hybrid instrument when put into practice.

For example, consider a 30 year zero coupon debenture issued at par that may be converted at the option of the investor into a fixed number of shares of stock (or equivalent cash value, at the option of the issuer) at any time after year 5. Assume that the only other features are a put option exercisable at par by the investor on the day after issuance (Day 2) and a call option by the issuer at par after year 5. One interpretation of the guidance in paragraphs 10 and 14 is that a similar debt instrument without the conversion feature would likely be put at par on Day 2 (and that the debt should therefore be valued at approximately par at issuance) since without the conversion feature there would be no incentive to hold the debt after the first put date. Another interpretation would be to conclude that a similar nonconvertible instrument would have had a different set of put and call features (for instance, at a different exercise price or on different dates), which creates the potential for consideration of numerous hypothetical scenarios. In reality, the put and call features in these instruments are designed around the conversion feature and, therefore, any hypothetical debt instrument excluding the conversion feature would be inherently arbitrary for instruments with such complex features.

Instead of requiring development of a hypothetical debt instrument, we believe the guidance on recognition and measurement can be simplified by referring back to the objective in paragraph 9. That is, under the Board's approach, we believe the liability component could be measured by reference to a) the expected life of the actual hybrid instrument (inclusive of the impact of the conversion feature and all other embedded features), b) the contractual cash flows of the actual hybrid instrument excluding any incremental settlement value from the conversion option (i.e., the expected cash flows would include the par repayment component of any expected conversion of the debt but not any excess conversion value), and c) the company's nonconvertible borrowing rate for a nonconvertible debt instrument with a maturity date equivalent to the expected life of the hybrid instrument.

Going back to our example of a 30 year debenture described above, if the issuer concluded that the expected life of the hybrid debt is 5 years (because that is the only opportunity for the issuer to curtail the life of the call option) and that its nonconvertible borrowing rate for a 5 year instrument is 8%, under our suggested model the debt component would be valued based on a $1,000 payment discounted for 5 years at 8%. The resulting discount to par would be amortized using the effective interest method over the 5 year expected life of the hybrid.

In summary, we believe using the expected life of the hybrid instrument for the valuation and amortization period of the debt component has the following advantages relative to the current proposed guidance:

a) It uses a nonconvertible borrowing rate over the expected period of the actual financing arrangement, not the period of a hypothetical financing arrangement that did not take place,

b) It can be applied by preparers and interpreted by users in a consistent manner, and

c) It provides a principle that cannot be overridden by assuming breakage between the expected behavior of the actual hybrid relative to a hypothetical debt instrument that does not exist in the marketplace.

Other Comments

Modification versus Extinguishment Accounting—Paragraphs 17 and 18 of the proposed FSP note that when a cash settled (or partially cash settled) conversion feature is either added, deleted, or replaced with a share settled conversion feature that EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments" and EITF Issue No. 06-6, "Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments" should be considered to determine whether modification or extinguishment accounting should be applied. Given the Board's decision in the proposed FSP that cash settled conversion features are different enough to require a dramatically different accounting model than the model for share settled convertibles under APB 14, we would have expected that a modification to add, remove, or replace a cash-settled conversion feature in a convertible debt instrument with a share settled instrument would inherently represent a significant modification that would require extinguishment accounting. As discussed earlier, we would support a revision to the scope of the guidance to include all convertible instruments under a single model. However, if the Board continues to believe that a conversion feature that may be cash settled should be treated differently from a conversion feature that must be share settled, we recommend that extinguishment accounting be required when a cash settled conversion feature is added or removed.

Accounting at Conversion—The proposed FSP requires an allocation of conversion value between the debt component and the equity component upon conversion of the hybrid instrument based on a residual value approach similar to the accounting at inception. While this seems reasonable, we note that the guidance for APB 14 convertible debt requires a simple reclassification of carrying values to equity upon conversion (no gain or loss) while the beneficial conversion feature literature (and the accounting in EITF Issue No. 06-7, "Issuers' Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133") requires all remaining debt discounts to be accreted through interest expense prior to reclassification to equity. As such, if the scope of the guidance is not expanded, there will be at least three different methods of accounting for convertible debt at conversion for four similar instruments (partially cash settled convertible debt, convertible instruments that have been structured to remain within APB 14, convertible instruments with a beneficial conversion feature, and convertible instruments that formerly contained an embedded derivative related to the conversion feature). We ask the Board to reconsider whether this level of complexity is necessary or meaningful. Each of these instruments represents a hybrid convertible instrument with an embedded written call option that meets the definition of an equity feature in Statement 133 and each has a similar economic payoff to the investor. In our view, the accounting at conversion for each of these instruments should follow a single principle and this variety of conversion accounting methods further highlights the desirability of applying a single recognition, measurement, and extinguishment model to all convertible instruments.

Applicability of FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments—Paragraph 12 of the proposed FSP notes that instruments within its scope are not eligible for the fair value option under Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities,* because the hybrid is partially classified in stockholders' equity. We believe the Board should clarify whether a similar logic would apply relative to the fair value election under Statement 155. We believe that the scope of Statement 155 and Statement 159 should be interpreted in a similar manner for instruments that are partially or wholly classified in stockholders' equity, however we understand there may be other views. Since the proposed FSP already makes reference to the fair value option under Statement 159, it would be helpful if paragraph 12 of the proposed FSP were clear on the application of the "other" fair value election in U.S. GAAP as well.

Transition—We believe full retrospective transition as proposed is appropriate, particularly if the Board expands the scope of the proposed guidance to include all convertible instruments. However, if the narrow scope is retained, "Instrument C" and similar instruments may be replaced prior to the effective date by convertible instruments that continue to be afforded APB 14 treatment. Requiring an entity to assemble valuation information for instruments that have been extinguished and replaced prior to the effective date may be burdensome and, due to the comparability concerns mentioned above, may be of limited information value. Therefore, if a narrow scope for the FSP is retained (i.e. if APB 14 is allowed to continue to apply to other convertible instruments), we believe that a limited retrospective application that is applicable only for instruments that are still outstanding (i.e. instruments that have not been extinguished, whether because of repayment or because of a significant modification) at the date of adoption would be acceptable. This approach is similar to the transition method used in EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share".

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If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Mark Bielstein at (212) 909-5419.

Sincerely,

KPMG LLP