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LETTER OF COMMENT NO. 55

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File Reference: Proposed FSP APB 14-a

Dear Mr. Golden:

We appreciate the opportunity to comment on the Proposed FASB Staff Position APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)" ("the Proposed FSP"). While we would have preferred that the Board had taken on a broader project addressing convertible debt instruments prior to the completion of its Liabilities and Equity Project, we support the Proposed FSP as it provides an incremental improvement to the transparency of reporting the economic costs of the convertible debt within its scope.

We have heard many issuers express concern over the effective date and transition provisions of the Proposed FSP. Their concerns have included the timing of the effective date, the availability of resources to adopt the new guidance on relatively short notice, the effect on corporate governance processes, and the fairness of dramatically "changing the rules." We have strongly encouraged those that have spoken with us to individually comment, and likewise encourage the FASB staff to carefully consider their comments as those issuers are first and foremost responsible for the adoption of the Proposed FSP.

We understand the rationale for the use of a retrospective approach to transition (retroactive restatement), but also note that the transition provisions for most of the recent EITF issues addressing convertible debt and related instruments have generally been prospective in nature. If the FASB staff retains the transition as proposed, we have two suggestions to somewhat mitigate the concerns of issuers, yet still reflect the effects of instruments that were within the scope of the Proposed FSP and maintain comparability among periods for instruments that are outstanding as of the effective date.



As noted above, we agree with the FASB staff's goal to present the economic costs of instruments that may be settled wholly or partially in cash for many of the same reasons as presented in the Basis for Conclusions. However, for debt instruments that can be modified prior to the effective date of the Proposed FSP by simply changing the consideration to be delivered on conversion, we would suggest the FASB staff consider not requiring the retroactive restatement of prior periods for the measurement of the liability component and recognition of interest expense at the rate for similar nonconvertible debt. That is, if an issuer can modify a convertible debt instrument in good faith without changes in any terms of the instrument other than the conversion consideration, and without the transfer of any additional value or consideration (except for de minimis legal fees or transaction costs to parties other than the investors), we believe that such an instrument could be excluded from the retroactive restatement exercise for its interest expense. The approach to respect the terms of the instrument based on a modification prior to the effective date is generally consistent with the transition approaches taken in EITF Issues 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" and 04-8, "The Effect of Continently Convertible Instruments on Diluted Earnings per Share." However, as such a modified instrument would have been subject to the if-converted method for diluted earnings per share, it would seem appropriate to require earnings per share to be retroactively restated.

Likewise, we suggest that the FASB staff exclude from the transition provisions any instrument that is no longer outstanding at the effective date, and retain the historical reporting for those instruments. This would be on the basis that reflecting the costs and earnings per share effects in the prior periods is not necessary for comparability with the future periods. This would be consistent with the transition approach taken in FASB Staff Position EITF 00-19-2, "Accounting for Registration Payment Arrangements"

Assuming the Proposed FSP is issued substantially as drafted, our technical comments follow, organized by subheading and paragraph within the Proposed FSP. Following these comments are our responses to the specific questions asked by the FASB staff.

## Recognition and Initial Measurement

Paragraph 10 – The Proposed FSP requires a portion of the initial proceeds to be attributed to any other stated or unstated rights and privileges based on their fair value (before allocating the residual proceeds to the equity component). Often, convertible debt instruments may be issued in conjunction with a registration rights agreement. Applied literally, the guidance would require recognizing that registration rights agreement at its fair value at issuance. However, we presume the FASB staff intended that any initial allocation to a registration rights agreement follow the

# **III** ERNST & YOUNG

Mr. Russell G. Golden October 15, 2007 Page 3

guidance in FSP EITF 00-19-2, if the transfer of consideration is probable and can be reasonably estimated at inception. That is, as required under FSP EITF 00-19-2, the contingent liability should be allocated proceeds from the related financing transaction using the measurement guidance in FASB Statement No. 5, *Accounting for Contingencies*. The FASB staff may want to consider whether there may be other situations (such as basket issuances of securities) where the proceeds are allocated to various components that may warrant an allocation other than fair value to the other components, and provide appropriate guidance or a more general statement to follow the other applicable literature.

Paragraph 10 – The Proposed FSP language requires that the issuer of the convertible debt instrument "shall first" measure the fair value of a similar liability that includes any embedded features other than the conversion option. Paragraph 11 requires that the guidance in FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, "shall be applied first" to determine if any potential embedded derivative features require bifurcation. The use of the word "first" in two places may be confusing. We believe the FASB staff intends an issuer to a) determine the fair value the liability component inclusive of all embedded derivative features (except the conversion option), then b) allocate the difference between the fair value of the liability component and the proceeds to the equity component, then c) evaluate whether any embedded derivative features need to be bifurcated from the liability component debt host, and finally d) bifurcate any required embedded derivative at its fair value from the liability component. We recommend the FASB staff clarify the wording appropriately.

Paragraph 11 - With regards to the evaluation of embedded prepayment features in convertible debt subject to the Proposed FSP, we do not believe that the allocation of proceeds to the equity component results in a discount to the debt host instrument that should be considered when analyzing any embedded puts and calls. For example, assume a convertible debt instrument subject to the Proposed FSP is issued for \$100, and the fair value of the liability component is \$80. When evaluating an embedded put option in the liability component under the guidance in paragraph 61(d) of Statement 133 and related guidance in Statement 133 Implementation Issue B16, "Calls and Puts in Debt Instruments," we believe it is incorrect to conclude the debt host was issued at a significant discount (\$20 in this example) as contemplated in this literature. As the settlement of the put and the settlement of the conversion option are mutually exclusive, we believe the entire proceeds of \$100 should be considered in the analysis of the put option. If the put is exercised, from the perspective of the investor, they will receive \$100 on redemption after investing \$100 in the instrument – thus they do not receive any windfall in redemption. While there may be diversity in this area, we believe our view is the most appropriate. Given the existence of put and call features in the vast majority of the instruments that will be subject to the Proposed FSP, we believe the FASB staff should address this issue.

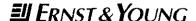


Paragraph 12 – We suggest that the FASB staff consider whether the election of the fair value option should be allowed in the event that the conversion option in a convertible instrument subject to the Proposed FSP subsequently requires bifurcation and separate accounting under Statement 133. Had that been the case at issuance, the fair value option would have been allowed under FASB Statement No 155, *Accounting for Certain Hybrid Financial Instruments*, and we believe the election should be allowed when a decision for subsequent bifurcation is reached.

### Subsequent Measurement

Paragraph 14 – We agree with the concept of amortizing the discount that results from the Proposed FSP over the "expected life" of a similar liability considering the effects of prepayment features. However, we believe there may be challenges with identifying what is the "expected life" of such an instrument when "considering the effects of prepayment features other than the conversion option" given the various combinations of puts and calls that can be embedded, as well as the economic interaction of those features with other embedded features. In addition, this new guidance may highlight several practice questions that the FASB staff may want to consider addressing. For example, we believe that currently accepted practice includes models for amortizing discounts and costs over the period to the first put date or the maturity date, and that this is an accounting policy election in the absence of specific guidance. Is there any concern that the Proposed FSP would lend support to an accounting policy to amortize costs or discounts over the period to the first call date if an issuer asserts that to be the "expected life," even if that does not correspond to the first put date in a debt instrument?

Paragraph 14 – We have received questions as to what would happen if an issuer were to amortize the discount under the Proposed FSP over the "expected life" of an instrument, only to find that the instrument is not prepaid on that date for whatever reason. We have also received questions as to whether the amortization period would change if the convertible debt instrument were modified (assuming extinguishment accounting was not required) to change that expected life (for example, the first put date is modified to delay it for X years). In the first case, we read the Proposed FSP to result in interest expense at the stated coupon rate from the end of the "expected life" forward, without any subsequent adjustment to the measurement or amortization of the discount. In the second case, we believe any remaining discount would be amortized to the modified put date, resulting in a new effective interest rate that is neither the market rate for nonconvertible instruments at issuance nor the current market rate for a nonconvertible instrument at the modification date. We suggest that the FASB staff consider providing additional clarity on those questions.



Paragraph 15 – The guidance in paragraph 15 for reclassification of the conversion option from equity to a liability is clearly intended to capture the concepts in EITF Issue 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock." However, we suggest using a clearer description for the accounting, such as "The fair value of the conversion option recorded as a liability on reclassification shall be offset by an entry to equity." In addition, we believe under the concepts in Issue 00-19 that such a reclassification, including any difference between the amount initially recorded in equity and the amount reclassified, would not affect earnings per share under the FASB's literature. However, if the staff of the Securities and Exchange Commission believes otherwise, some form of communication of that view would be helpful to registrants.

## Modification and Derecognition

Paragraphs 16, 17, and 18 – These paragraphs all describe the accounting for a modification of convertible debt instruments that are either within the scope of the Proposed FSP initially or that are not within the scope but become subject to the scope. In each case, the guidance refers to EITF Issues 96-19, "Debtor's Accounting for a Modification (or Exchange) of Debt Instruments" and 06-6, "Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments." However, it is not apparent in either of these EITF issues how to address modifications to instruments in which the embedded conversion option is bifurcated and separately accounted for under Statement 133 either prior to, subsequent to, or both prior to and subsequent to the modification. In fact, Issue 06-6 specifically excludes such modifications from its scope. We suggest the FASB staff consider whether additional guidance is necessary in this area given the importance of the modification literature to the application of the Proposed FSP and possible issuer reactions to the Proposed FSP.

Paragraph 18 – If a convertible instrument is modified such that it becomes subject to the Proposed FSP, the allocation to the liability component is based on a fair value measurement as of the modification date. However, if the only modification made to that debt is the form of consideration on conversion (that is, no other terms are changed, such as maturity date, interest rates, conversion ratios, etc.), then some would argue that economically nothing is different, and the instrument should bear the market rate as of the date it was issued, rather than the market rate as of the date it was modified. This concept is especially relevant in the retroactive restatement periods for contingently convertible debt instruments that were modified to become "Instrument C" as a result of the conclusions in EITF Issue 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share." For example, if an instrument issued in January 2002 (when the rate for nonconvertible debt was 5%) was modified in November 2004 (when the

# **III** ERNST & YOUNG

Mr. Russell G. Golden October 15, 2007 Page 6

rate for nonconvertible debt was 8%) to be "Instrument C" in response to EITF 04-8, the modified instrument under the Proposed FSP would bear the 8% market rate of interest for nonconvertible debt issued in November 2004, rather than the 5% rate appropriate for a nonconvertible instrument priced and issued in January 2002. One could argue that the appropriate rate would the market rate at original issuance, given the only change to the instrument was the consideration on conversion and nothing else that would substantively affect the fair value or other economic characteristics of the instrument. We believe the FASB staff should consider whether an instrument bearing a market effective rate based on the date of modification is appropriate if nothing has changed since issuance other than the form of consideration on conversion.

Paragraph 19(a) — When following extinguishment accounting, we believe the FASB staff intends for the issuer to initially measure the fair value of any new instrument issued in settlement, if that instrument is within the scope of the Proposed FSP, at the fair value for the integrated instrument. Based on the language in the Proposed FSP requiring an issuer to "measure the new instrument at fair value (including both the liability and equity components if the new instrument is within the scope of this FSP)," we are concerned that some may read the Proposed FSP to require valuing that instrument as the sum of the fair values of the liability and equity components. We recommend the FASB staff clarify the language in paragraph 19(a) accordingly.

Paragraph 19 and 20 - We believe the model for derecognition accounting allows for an accounting arbitrage opportunity between extinguishment accounting and induced conversion accounting. In the case of extinguishment accounting, the gain or loss is based only on the difference between the recorded liability component and its fair value on that date. All additional amounts are reflected in equity without an earnings or earnings per share effect. That model enables the issuer to in essence pay any amount of premium for the debt without that premium affecting earnings. The same is not true for an induced conversion, where the excess fair value delivered over the fair value of the consideration issuable under the original terms is reflected as an expense, along with the difference between the recorded liability component and its fair value, with the remainder reflected in equity. As such, we believe issuers would rather extinguish debt than induce conversion. For example, assume an issuer wants to "terminate" its debt early, and does so by offering to pay the holder a fixed amount, but delivering that consideration in shares worth that fixed amount. If the fair value of that number of shares is in excess of the fair value of the consideration that would be received if converted under the original terms, is that an induced conversion as shares were issued, or an extinguishment paid for in shares? As described in the Proposed FSP, an induced conversion is a situation where, "An entity may amend the terms of an instrument within the scope of this FSP to induce early conversion, for example, by offering a more favorable conversion ratio or paying other additional consideration in the event of



conversion before a specified date." We believe that given the tension that may exist between the two models, the FASB staff should consider whether additional guidance is necessary to clearly articulate what constitutes an induced conversion, perhaps drawing on specific language from FASB Statement No. 84, *Induced Conversions of Convertible Debt*, rather than merely referencing that standard in paragraph B17 of the Basis for Conclusions.

#### Effective Date and Transition

Paragraph 21 – We believe the FASB staff should consider whether early adoption should be allowed, or provide the basis for prohibiting early adoption.

Paragraph 22 – If the retroactive restatement provisions are retained in the final FSP, we believe many entities will face issues that the FASB staff may wish to address. Some of these issues may have an answer within FASB Statement No. 154, Accounting for Changes and Error Corrections. However, we observe that the Proposed FSP requires retrospective application, but does not specifically invoke retrospective application in accordance with Statement 154. Paragraph B21 in the Basis for Conclusions of the Proposed FSP references the Basis for Conclusions in Statement 154, but does not invoke it directly. The potential issues on retroactive restatement could include:

- 1) If the issuer had been amortizing some amounts related to the convertible debt over a period other than the expected life that considered prepayment features (for example, amortizing issuance costs to the stated maturity date), should the issuer be allowed to adopt a different accounting policy in the retroactive restatement process and align the amortization periods for all discounts or costs that require amortization and are associated with a single instrument?
- 2) If the issuer knows with hindsight when a debt issuance was converted or prepaid in the retroactive restatement period, and that date for some reason was different than what would have been the expected life of the debt at issuance that considered prepayment features, should the issuer be allowed to use that perfect hindsight?
- 3) If formulaic bonus plans or other expenses or accruals that are based on net income would be different given the higher interest expense, should those be retroactively restated as well?
- 4) Issuers with "Instrument X" outstanding (that is, convertible debt settled in any combination of cash or shares at the option of the issuer) have historically had to make a policy election as to how to calculate the earnings per share effect, selecting between the if-converted method and the treasury stock method afforded Instrument C. At the December 2003 AICPA National Conference on Current SEC Developments, a SEC staff



member provided his views on the importance of a registrant's representations as to the expected method of settling Instrument X. Should this retroactive restatement provide those issuers with an opportunity to revisit their accounting policy or assertions in the restatement period?

Paragraph 22- If capitalized interest under FASB Statement No. 34, Capitalization of Interest Cost, is a component of assets that an enterprise constructs for its own use or assets intended for sale or lease that are constructed as discrete projects, then retroactive restatement may present a significant challenge. For example, the asset balances, accumulated depreciation, depreciation expense, and potentially even costs of sales and asset impairments will all need to be determined. As currently drafted, there is no exception to retroactive restatement allowed, even where impracticable (which is discussed in Statement 154). We believe the FASB staff should at least consider whether such an exception is appropriate in the Proposed FSP, or if other such exceptions should be made in the application of retroactive restatement.

#### **Basis for Conclusions**

Paragraphs B8 and B20 – As currently drafted, paragraph B8 could be read to indicate that the issuer of a convertible debt with a "bond hedge" (a purchased call option that offsets the written call option in the convertible debt) has all the information necessary for the determination of the liability component given the tax treatment of the integrated transaction. We question whether this is accurate. Assuming the purchased call option is essentially equal but opposite in value to the written call option in the convertible debt, we believe that the net of the convertible debt and purchased option is not necessarily the fair value of the liability component, as frequently the fair value of the convertible debt is not equal to the sum of the fair values of the parts. For example, any puts or calls in the debt host may result in a fair value that is different than just subtracting the value of the purchased call from the proceeds of the convertible debt issuance. If the FASB staff believes this to be an acceptable expedient, then that should be clearly stated. However, it would then beg the question as to why valuing the liability component first is really necessary.

### Specific Questions in the Proposed FSP

1. This proposed FSP requires that instruments within its scope be separated into their liability and equity components at initial recognition by (a) recording the liability component at the fair value of a similar liability that does not have an associated equity component and (b) attributing the remaining proceeds from issuance to the equity component. The rationale for the Board's decision to require this separation methodology for convertible debt instruments within the scope of this proposed FSP is described in Appendix B. Do you agree with this method of separation?



Would this proposed FSP be easier to apply if separation were achieved by (a) recording the embedded conversion feature (equity component) at its fair value and (b) attributing the remaining proceeds from issuance to the liability component?

Given the stated objective of the Proposed FSP, the method of separation is appropriate. We have provided specific comments above.

2. This proposed FSP provides guidance on the attribution of proceeds at initial recognition and at settlement for convertible debt instruments within its scope. It also requires that discounts on the liability component of instruments within its scope be amortized using the interest method over the expected life of a similar liability that does not have an associated equity component (considering the effects of prepayment features other than the conversion option). The remaining guidance in this proposed FSP, including much of the guidance on subsequent measurement and accounting for modifications, primarily consists of references to other applicable U.S. generally accepted accounting principles (GAAP). Does the inclusion of those references to other applicable U.S. GAAP improve the understandability of this proposed FSP, or should those references be eliminated from a final FSP?

The inclusion of the references to other applicable U.S. GAAP is helpful by providing a more direct reference to associated literature as opposed to leaving the practitioner to identify the other guidance.

3. Does the inclusion of the illustrative example in Appendix A improve the understandability of the guidance in this proposed FSP, or should that example be eliminated from a final FSP?

We believe the example in Appendix A is essential in the Proposed FSP.

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We would be pleased to discuss our comments with the Board members or the FASB Staff at your convenience.

Sincerely,

Ernst + Young LLP