

October 17, 2007

Mr. Russell Golden
Director, TA&I — FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 49

File Reference No. FSP APB 14-a

Re: 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:

Deloitte & Touche LLP is pleased 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)” (the “proposed FSP”).

We support addressing the accounting for convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement). However, we recommend that the Board broaden the scope of the proposed FSP by adding a short-term project to its agenda to address the issuer’s accounting for all convertible instruments. This broader project should focus on simplifying the issuer’s accounting for convertible debt instruments by reducing the number of different models that currently exist for (1) bifurcation (or lack thereof) of the equity component, (2) subsequent measurement of the debt component, and (3) modification and derecognition of convertible debt.

In that project, the Board should consider amending Opinion 14,¹ Issue 90-19,² Issue 98-5,³ and Issue 00-27⁴ to require bifurcation of the equity component in convertible debt under the same principles as those proposed in the FSP, which are consistent with the current accounting framework’s definition of equity. In addition, rather than using the current relative fair value method, the Board should consider amending Opinion 14 to require that entities allocate proceeds to debt with detachable warrants classified in equity on the basis of the fair value of the debt. We acknowledge and support the Board’s longer-term project on liabilities and equity (including revisiting the current accounting framework’s definition of equity), but believe there is a short-term need to reduce complexity in accounting for convertible instruments in a broader manner than that currently described in the proposed FSP.

¹ APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants.*

² EITF Issue No. 90-19, “Convertible Bonds With Issuer Option to Settle for Cash upon Conversion.”

³ EITF Issue No. 98-5, “Accounting for Convertible Securities With Beneficial Conversion Features or Contingently Adjustable Conversion Ratios.”

⁴ EITF Issue No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments.”

Our more significant comments and recommendations regarding the proposed FSP follow. (Appendix A contains other suggestions for improving the clarity of the proposed FSP.)

Beneficial Conversion Features

If the Board chooses not to take on a broader project to simplify and conform the issuer's accounting for all convertible debt instruments, we encourage the Board to broaden the scope of the proposed FSP by including convertible debt with beneficial conversion features (BCFs). The purpose would be to reduce the number of accounting models for convertible debt in which the conversion option is bifurcated and recognized in equity. This would conform or replace the bifurcation, subsequent measurement, and extinguishment guidance for BCFs in Issue 98-5 and Issue 00-27 with the guidance in the proposed FSP.

For example, we recommend that the Board replace the existing "intrinsic value of the conversion option" approach for BCFs with the "fair value of the liability" approach outlined in the proposed FSP. We also recommend replacing the "stated redemption date" guidance in the existing BCF literature with the "expected life" guidance in the proposed FSP for subsequent measurement of debt discounts and debt issue costs. Lastly, we recommend replacing the guidance for extinguishments in the existing BCF literature with the approach in the proposed FSP.

Expected Life

The concept of expected life requires some additional clarification. While we do not believe that the Board needs to prescribe how an entity should determine the expected life, it would be useful if the FSP established the concept's underlying principles to help address certain issues that are likely to arise in practice, including:

- *Convertible debt puttable by the holder (or callable by the issuer).* The Board should clarify whether, in determining expected life, entities should (1) use the earliest exercise date or (2) consider probability to predict when the holder or issuer will exercise. We recommend the Board indicate that entities should consider probability of exercise of the redemption option (i.e., the earliest exercise date is not necessarily equal to the expected life).
- *Convertible debt with contingent put features (unrelated to conversion option) — e.g., a put feature that becomes exercisable on the basis of a market price trigger.* The Board should clarify whether the resolution of a contingent put feature results in the immediate write-off of any remaining debt discount, a reassessment of the expected life of the debt, or no change to the expected life of the debt. We recommend that the Board clarify that the resolution of a contingent put feature does not always result in an immediate write-off of any remaining debt discount. With respect to reassessment of the expected life, see additional discussion below.

The Board should indicate whether entities need to reassess the expected life of the debt, and if so, whether they should perform this reassessment on an ongoing basis or only in certain circumstances. We note that IFRSs have such a requirement and that the reassessed expected life may provide more useful information. However, we also note that reassessing the expected life adds to the burden and increases the complexity in applying the guidance. We recommend that the Board seek input from users and preparers regarding the cost and benefits of reassessing the expected life.

Income Tax Accounting

The Board should reconsider the guidance in paragraph 13 of the proposed FSP, which indicates that “[r]ecognizing convertible debt instruments within the scope of this FSP as two separate components — a debt instrument and an equity component — **may result in a basis difference associated with the liability component that represents a temporary difference . . .**”

[Emphasis added] In our view, a deferred tax liability should not be recorded upon issuance of the convertible debt instrument because no basis difference exists under Statement 109.⁵

Furthermore, the proposed tax accounting would result in an understatement of the issuer’s after-tax borrowing cost. Our rationale is as follows:

- We believe it is inappropriate, in determining whether a basis difference exists, to compare the book basis of the convertible instrument on a bifurcated basis (i.e., only the debt component) to the tax basis of the instrument on a combined basis (i.e., both the debt and equity components). By doing so, one is essentially comparing two different instruments: one with a conversion option (tax basis) and one without a conversion option (book basis). This is not an apples-to-apples comparison and results in an inappropriate conclusion that a temporary difference is created upon issuance of a convertible debt instrument when proceeds received upon issuance equal its tax basis; accordingly, a deferred tax liability should not be recognized upon issuance. We think that the carrying values of the debt and equity components for financial reporting purposes should be combined when determining whether a basis difference exists, given that the debt host cannot be settled without a contemporaneous settlement of the equity component.
- Treatment of the book amortization of the original issuance discount, when not deductible for tax purposes, should be accounted for as a permanent difference under Statement 109. This accounting treatment reflects the issuer’s after-tax borrowing cost and is consistent with the Board’s stated objective of requiring the entity to recognize the same interest cost it would have incurred had it issued a comparable debt instrument without the embedded conversion option.
- In addition, if the Board were to require recognition of a deferred tax liability upon issuance of a convertible debt instrument, we do not understand the basis for recording the income tax accounting journal entries in paragraph A10 of the proposed FSP — in particular, the credit to additional paid-in capital in the amount of \$8,901,000. It is unclear to us what accounting literature would permit this accounting. Under paragraph 289 of Statement 109, “deferred tax expense or benefit” is defined as “[t]he change during the year in an enterprise’s deferred tax liabilities and assets,” and paragraphs 35 to 38 provide Statement 109’s requirements on intraperiod allocation of income tax expense. If the Board believes it is appropriate to reverse the remaining deferred tax liability after adjustment for any extinguishment loss tax effects, the Basis for Conclusions should clarify where Statement 109’s intraperiod allocation guidance provides for this application.

We recommend the Board change the guidance in the proposed FSP by indicating that when the settlement of a convertible instrument at its carrying value (the sum of the carrying value of the debt and equity components) will not result in taxable or deductible amounts, a temporary difference does not exist.

⁵ FASB Statement No. 109, *Accounting for Income Taxes*.

We recognize that the guidance in the proposed FSP is consistent with that in Issue 05-8.⁶ We agree that income taxes associated with convertible debt with a BCF should be accounted for similarly to income taxes associated with convertible debt within the scope of this proposed FSP, since the accounting model for both would be to bifurcate and allocate the conversion option to equity. Therefore, we believe the Board should modify the consensus in Issue 05-8 to be consistent with our recommendations above.

Decision Tree — We recommend that the Board include a decision tree diagramming the steps in applying the proposed FSP. For example, the decision tree could illustrate (1) how the embedded derivatives guidance in paragraph 11 of the proposed FSP interacts with the bifurcation guidance in paragraph 10 of the proposed FSP and (2) the steps involved in applying the modification and derecognition guidance in paragraphs 16–20 of the proposed FSP.

Transition — While we prefer limited retrospective application, given that entities issued convertible instruments within the scope of the proposed FSP having appropriately applied the accounting guidance in effect at the time, we would not object to prospective application with appropriate disclosures. If the Board does require retrospective application, we recommend limiting retrospective application to those instruments outstanding at the date of adoption, thus easing the burden on preparers and auditors.

Appendix B contains our responses to the notice to recipients' questions.

We appreciate the opportunity to comment on the proposed FSP. If you have any questions concerning our comments, please contact Magnus Orrell at (203) 761-3402.

Yours truly,

Deloitte & Touche LLP

cc: Robert Uhl
James A. Johnson

⁶ EITF Issue No. 05-8, "Income Tax Consequences of Issuing Convertible Debt With a Beneficial Conversion Feature."

- Appendix A -
Our Comments and Suggestions for Improving the Clarity of the Proposed FSP

Paragraph 7 — We agree with the scope exceptions in paragraph 7. However, we believe that the first scope exception (i.e., conversions occurring in connection with a change in control), as currently written, is too narrow. We suggest modifying this scope exception to establish a principle. In establishing that principle, the Board should consider the guidance in paragraphs 12 and 28 of Issue 00-19,⁷ which state, in part:

12. Contracts that include any provision that could require net-cash settlement cannot be accounted for as equity of the company (that is, asset or liability classification is required for those contracts), **except in those limited circumstances in which holders of the underlying shares also would receive cash** (see discussion in the last sentence of this paragraph and in paragraph 27, below). . . . Those conclusions do not allow for an evaluation of the likelihood that an event would trigger cash settlement (whether net cash or physical), **except that if the payment of cash is only required upon the final liquidation of the company**, then that potential outcome need not be considered when applying the consensus in this Issue. [Emphasis added]

28. The Task Force was advised that, in the event of nationalization, cash compensation would be the consideration for the expropriated assets and, as a result, a counterparty to the contract could receive only cash, as is the case for a holder of the stock underlying the contract. Because the contract counterparty would receive the same form of consideration as a stockholder, **a contract provision requiring net-cash settlement in the event of nationalization does not preclude equity classification of the contract.** [Emphasis added]

Paragraph 11 — Some may incorrectly conclude that applying the bifurcation guidance in the proposed FSP could result in a requirement to separate an embedded derivative that would not otherwise have been separated. We recommend that the Board provide the following example to emphasize that the bifurcation guidance in the proposed FSP should not result in an embedded derivative requiring separation in accordance with Statement 133:⁸

Assume that an entity issued for par convertible debt, redeemable at par, which is subject to the guidance in the proposed FSP. Further, assume that the entity first applies the bifurcation guidance in the proposed FSP, bifurcating the conversion option and creating a significant discount on the debt component. Next, the entity evaluates the put feature to determine whether it is an embedded derivative requiring bifurcation in accordance with Statement 133. Provided that the debt is determined to have a significant discount, the holder could put the debt and double its initial rate of return, and the return is double the then market rate of return (see paragraph 13 of Statement 133), the entity might conclude it has an embedded derivative requiring bifurcation. Alternatively, by applying Statement 133 first as paragraph 11 of the proposed FSP indicates, the entity would conclude that there is not an embedded derivative. This is because there would not be a significant discount.

⁷ EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock.”

⁸ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Paragraph 14 — The proposed FSP indicates that “[t]he excess of the principal amount of the liability component over its **initial fair value** shall be amortized to interest cost using the interest method” [Emphasis added]. We suggest replacing the phrase “initial fair value” with “initial carrying amount of the liability component” to provide for circumstances in which there is an embedded derivative requiring bifurcation.

Paragraph 16 — When a modification does not result in an extinguishment, Issue 96-19⁹ requires use of the “remaining term” to accrete any discount. The proposed FSP requires the use of the expected life when the debt discount created upon bifurcation is amortized. We recommend the Board clarify the proposed FSP to indicate that entities should also use the expected life when a modification that does not result in an extinguishment has occurred. Under the proposed FSP, as currently written, a minor modification could cause a significant change in the amortization period (i.e., a change from expected life to remaining term). The Board should also clarify whether entities should reassess the expected life (see prior comments and suggestions in our opening remarks).

Paragraph 17 — We note that this paragraph requires the application of Issue 06-6¹⁰ to determine whether an extinguishment has occurred. The Board should clarify the proposed FSP to indicate whether an entity should apply Issue 06-6’s guidance referring to “the carrying value of the original debt instrument” on the basis of the carrying amount of the debt component or the aggregate carrying amount of both the debt and equity components. We believe the aggregate carrying amount of both the debt and equity components is more appropriate.

Paragraph 19(b) — We suggest placing bullet 3 before bullet 2 to be consistent with the allocation order.

Balance Sheet Classification — When a conversion contingency is resolved, it is practice for entities with classified balance sheets to reclassify Instrument C from long-term to current because, after the resolution of the conversion contingency, the accreted value could be settled in cash at any point. This occurs even if the debt has a remaining term of more than a year and is supported (by analogy) to Statement 78.¹¹ Some may interpret the proposed FSP’s requirement to ignore the conversion option as meaning that the conversion option can also be ignored for purposes of balance sheet classification. In addition, some may question whether the expected life should be used to determine the classification of the debt component. The Board should clarify that the proposed FSP does not change balance sheet classification practices.

⁹ EITF Issue No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments.”

¹⁰ EITF Issue No. 06-6, “Debtor’s Accounting for a Modification (or Exchange) of Convertible Debt Instruments.”

¹¹ FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor* — an amendment of ARB No. 43, Chapter 3A.

**- Appendix B -
Responses to Notice to Recipients' Questions**

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?

Deloitte's Response:

We agree with the FASB's decision. As noted in Appendix A, paragraph 11 of our letter, we suggest the Board include an example illustrating that application of the bifurcation approach in the proposed FSP does not create additional embedded derivatives.

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?

Deloitte's Response:

Please see our opening remarks regarding the term expected life. The references are helpful.

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?

Deloitte's Response:

The illustrative example in Appendix A does improve the understandability of the guidance in the proposed FSP and should be included.