

FASB Emerging Issues Task Force

Issue No. 98-5

Title: Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios

Document: Status Update and Other Related Matters*

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Previously distributed EITF materials: Proposed EITF Issue Clarification, dated November 29, 2007

References:

FASB Statement No. 128, *Earnings per Share* (FAS 128)

FASB Statement No. 129, *Disclosure of Information about Capital Structure* (FAS 129)

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Staff Position FAS 150-1, *Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations under FASB Statement No. 150* (FSP FAS 150-1)

*** The alternative views presented in this Status Update are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Statement 133 Implementation Issue No. B15, "Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument" (DIG Issue B15)

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments" (Issue 00-27)

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" (Issue 00-19)

EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock" (Issue 07-5)

Background

Issue 98-5

1. Issue 98-5 addresses (a) the accounting for convertible debt instruments and convertible preferred stock with nondetachable conversion features that are in-the-money at the commitment date and (b) an issuer's accounting for convertible instruments that have conversion prices that are variable based on future events.

Issue 00-27

2. Subsequent to the consensus on Issue 98-5, a number of application issues about the Issue 98-5 model were raised. Consequently, Issue 00-27 was added to the EITF agenda to address certain practice issues resulting from application of the Issue 98-5 model. Additionally, a Working Group was formed to assist with addressing such application issues. At the November 15–16, 2000 EITF meeting, the Task Force reached a consensus on Issue 00-27 to maintain the existing Issue 98-5 framework (Part I of Issue 00-27). At that meeting, the Task Force also reached a number of consensuses on application issues relating to the Issue 98-5 model (Part II of Issue 00-27).¹ Certain of those consensuses (Issues 4 and 6) superseded portions of the guidance in Issue 98-5 and affected the illustrative examples in that Issue.

3. Subsequently, the Working Group and Task Force discussed various other issues but did not reach any consensuses on those issues.² On March 19, 2001, the Working Group met and determined that work on Issue 00-27 should cease pending developments on the FASB's liabilities and equity project. No further discussion was held by the Task Force.

4. As stated above, certain consensuses in Issue 00-27 superseded portions of Issue 98-5. A general status update that included transition guidance was added to Issue 98-5 to acknowledge

¹ At the November 15–16, 2000 EITF meeting, consensuses were reached on Issues 1–8, 10, and 11 of Issue 00-27. The Task Force decided that Issue 9 should be addressed as a separate EITF Issue and it was removed from Issue 00-27. Additionally, the Task Force reached three tentative conclusions on Issues 12(a), 12(b), and 12(c).

² At the January 17–18, 2001 EITF meeting, tentative conclusions were reached on Issues 13(a), 13(b), 13(c), 14, 15, and 16(b). The Task Force reaffirmed its tentative conclusions on Issues 12(a) and 12(b) from the November 15–16, 2000 EITF meeting, but was not asked to reach a final consensus on those Issues. The Task Force also discussed the tentative conclusion previously reached on Issue 12(c) and reached a different tentative conclusion. The Task Force did not reach a tentative conclusion on Issue 16(a), regarding the need for specific presentation and disclosure requirements for convertible instruments subject to Issues 98-5 and 00-27. However, the Task Force did observe that FAS 128 and FAS 129 set forth disclosure requirements that apply to all convertible instruments.

the issuance of Issue 00-27. However, the portions of Issue 98-5 that were nullified by the consensuses in Issue 00-27 were not specifically identified within the Issue 98-5 abstract, nor were the illustrative examples in Issue 98-5 updated for the effects of the consensuses in Issue 00-27.

Statement 150

5. FAS 150 was issued in May 2003. Instruments within the scope of FAS 150 are accounted for pursuant to the guidance in that Statement and are not within the scope of Issues 98-5 and 00-27. Upon issuance of FAS 150, a status update was added to Issue 00-27 clarifying that instruments within the scope of FAS 150 are no longer within the scope of Issue 00-27. However, a status update for FAS 150 was not included in Issue 98-5, even though instruments within the scope of FAS 150 are no longer within the scope of Issue 98-5 and certain application examples in Issue 98-5 illustrate instruments that appear to be within the scope of FAS 150 and, therefore, such examples should have been nullified by that Statement.

Recent Developments

6. The FASB staff was informed by a constituent that some companies were continuing to follow the guidance in Issue 98-5 that had been nullified by either Issue 00-27 or FAS 150. That constituent requested that the FASB staff eliminate the nullified guidance from Issue 98-5 and incorporate appropriate references to the current guidance. The FASB staff agreed with that request and, at the November 29, 2007 EITF meeting, proposed to (a) replace the superseded guidance in Issue 98-5 with the current guidance in Issue 00-27, (b) update the illustrative examples in Issue 98-5 to reflect the current guidance in Issue 00-27, (c) add status update discussion in Issue 98-5 relating to FAS 150, (d) delete the illustrative examples in Issue 98-5 that are within the scope of FAS 150, and (e) delete an illustrative example in Issue 98-5 that requires interpretations of various pieces of subsequently issued accounting literature that are not currently reflected in that example.

7. Certain Task Force members noted concerns with the format of the changes and asked the staff to consider modifications to Issue 98-5 that would (a) retain the nullified guidance, noting that such guidance applies to instruments with a commitment date that occurred prior to

November 16, 2000, and (b) incorporate the current guidance into the abstract and its examples. The FASB staff has drafted a modified version of Issue 98-5 based on the request of the Task Force (see Appendix 98-5A to this Issue Summary).

8. Additionally, the Task Force raised the following concerns, which were subsequently added to the Task Force's agenda by the EITF Agenda Committee at its January 10, 2008 meeting:

- Whether transition guidance for any clarifications to Issue 98-5 is needed
- Whether further clarification to Issue 98-5 is needed regarding its applicability to features that provide for a fixed payoff, which may be settled in shares, if the instrument is not within the scope of FAS 150.

Accounting Issues and Alternatives

Issue 1: Whether transition guidance should be provided for conforming changes to Issue 98-5.

9. As discussed above, at the November 29, 2007 EITF meeting, the FASB staff proposed to (a) replace the superseded guidance in Issue 98-5 with the current guidance in Issue 00-27, (b) update the illustrative examples in Issue 98-5 to reflect the current guidance in Issue 00-27, (c) add status update discussion in Issue 98-5 relating to FAS 150, (d) delete the illustrative examples in Issue 98-5 that are within the scope of FAS 150, and (e) delete an illustrative example in Issue 98-5 that requires interpretations of various pieces of subsequently issued accounting literature that are not currently reflected in that example.

10. Some Task Force members questioned whether transition guidance relating to the conforming changes to Issue 98-5 was needed because, as previously discussed, some companies were following the guidance in Issue 98-5 that was amended by subsequent accounting literature.

View A: Provide transition guidance for all conforming changes made to Issue 98-5.

11. There may have been instances in practice in which preparers continued to apply certain guidance in Issue 98-5 after such guidance was nullified by Issue 00-27 or FAS 150. Although application of Issue 98-5 without the consideration of subsequent amendments could be considered an error, some believe that transition guidance for related transactions is necessary as Issue 98-5 was not updated to reflect changes resulting from the issuance of Issue 00-27 and FAS 150. For example, the illustrative examples in Issue 98-5 that were affected by the subsequent guidance were never updated.

12. Additionally, the Status section of Issue 98-5 contains only a brief discussion of the impact of Issue 00-27 and contains no discussion of FAS 150. The discussion of Issue 00-27 is limited to when Issue 00-27 is applicable but not how the guidance amends Issue 98-5.

13. If the Task Force supports View A, transition guidance and an effective date will need to be determined (refer to Issue 1(a) below).

View B: Provide no transition guidance.

14. No transition guidance should be provided for the conforming changes made to Issue 98-5. The consensuses in Issue 00-27 indicate how the guidance in Issue 98-5 changed. For example, paragraph 19 of Issue 00-27 states that “The Task Force reached a consensus that the Issue 98-5 model should be modified for convertible instruments that have a stated redemption date (such as debt and mandatorily redeemable preferred stock) to require....” Proponents of View B assert that the Status section of Issue 98-5 includes a discussion of Issue 00-27; accordingly, the appropriate amount of information was provided to indicate that Issue 00-27 was effective and should be followed. Therefore, no transition guidance relating to these conforming changes should be provided.

15. In regards to the FAS 150 conforming changes, although no reference to FAS 150 was included in the Status section of Issue 98-5, FAS 150 is a higher level of authoritative literature.

As such, preparers are required to use the higher level of authoritative literature if a conflict exists when determining the appropriate accounting for a particular transaction. Therefore, no transition guidance should be provided for those conforming changes.

16. View B proponents observe that subsequent to the November 29, 2007 EITF meeting, the FASB staff has not received a request for transition guidance for the conforming changes to Issue 98-5 from issuers of convertible debt with beneficial conversion features. Rather, certain Task Force members suggested that transition might be necessary. However, some of those concerns were expressed primarily in the context of paragraph 25 of the draft Status section update for Issue 98-5, which was included in the Proposed EITF Issue Clarification for Issue 98-5 discussed at the November 29, 2007 EITF meeting. Now that paragraph 25 has been removed, at the request of the Task Force, from the Issue 98-5 Status section update and is being redeliberated as a separate issue with its own transition provisions (refer to Issue 2 herein), View B proponents are not clear whether it is necessary to provide transition for the remaining conforming changes.

17. View B proponents also observe that it is unprecedented for the EITF to provide for a second transition date for changes that originally provided transition in the form of a cumulative effect adjustment many years earlier. View B proponents assert that the issuance of Issue 00-27 and FAS 150 were mandatory changes in accounting principle that required the need for transition guidance and that this exercise is simply to clarify how the previous guidance was impacted. There is no change in accounting principle being required by the conforming changes; accordingly, no transition guidance is necessary.

Issue 1(a): What is the appropriate effective date and transition guidance for the conforming changes to Issue 98-5?

18. If the Task Force supports View A of Issue 1, transition guidance and an effective date will need to be determined. If View A is supported, the conforming changes should be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, with earlier application permitted. The impact of applying the

conforming changes, if any, should be presented retrospectively with the cumulative-effect of the change being reported in retained earnings in the statement of financial position as of the beginning of the first period presented. Additionally, any transition impact of applying these conforming changes should comply with the disclosure requirements of FAS 154 for changes in accounting principles. Considering the fact that these conforming changes are clarifying existing authoritative literature and no new authoritative literature is being issued, the effective date should be as soon as possible. The effective date of December 15, 2008, is recommended based on the time required for the issuance of a draft abstract, the comment period, redeliberations by the Task Force, issuance of a final document, and implementation by preparers.

19. Retrospective application is recommended for comparative purposes as the conforming changes are clarifications to existing authoritative literature. Furthermore, the staff believes that the comparability benefit provided by retrospective application exceeds the costs of applying the conforming changes due to the mechanical nature of making such adjustments. Furthermore, the population of convertible instruments with beneficial conversion features is limited.

20. Alternatively, the effects of the conforming changes can be recognized by entities (a) as of the beginning of the fiscal year the conforming changes are applied for all financial instruments with beneficial conversion features existing as of the effective date (with the cumulative effect of the change recognized as an adjustment to the opening balance of retained earnings for that fiscal year) or (b) on a prospective basis to transactions entered into after the effective date.

Issue 2: Whether convertible instruments that have terms that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than a certain amount, should be evaluated as having (1) a single compound embedded feature (that is, one embedded feature with the characteristics of a share-settled “put warrant”) or (2) two separate embedded features (that is, an embedded put option and an embedded conversion feature).

21. At the November 29, 2007 EITF meeting, the FASB staff presented the following clarification to Issue 98-5 to reflect the effect of FAS 150:

24. Statement 150 was issued in May 2003 and is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the interim period beginning after June 15, 2004, except for mandatorily redeemable financial instruments of a nonpublic entity. Statement 150 establishes standards for issuer's classification and measurement of certain financial instruments with characteristics of both liabilities and equity and requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances).

25. A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that is convertible into a variable number of equity shares based solely or predominantly on a fixed monetary amount known at inception (for example, stock-settled debt) is within the scope of Statement 150.³ **A provision in a financial instrument that requires (or permits at the issuer's discretion) settlement by issuance of a variable number of shares that have a value equal to a fixed monetary amount is not a conversion option for purposes of applying Issue 98-5. Rather, such provisions should be evaluated as redemption features under other applicable guidance (for example, Statement 150, Statement 133, and Opinion 21).** [Emphasis added.]

At that meeting, some Task Force members observed that the language in the last two sentences of paragraph 25 was not limited to instruments within the scope of FAS 150. Financial instruments with a conversion feature that requires settlement through the issuance of a variable number of equity shares equal to a fixed monetary value are within the scope of FAS 150, paragraph 12(a). However, certain financial instruments have terms that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than that fixed monetary amount. Such a financial instrument provides the holder with a guaranteed minimum value upon settlement and allows the holder to participate in the upside return as the number of shares to be received is fixed upon meeting the share price threshold. Those instruments are often economically equivalent to convertible debt issued at a discount, except that shares are issued at

³ The first sentence of paragraph 25 has been edited to reflect drafting suggestions received by the FASB staff. Such changes conform the verbiage to FAS 150.

settlement regardless of whether the conversion feature is in-the-money. Case 1(d) of Issue 98-5 provides an illustrative example of such an instrument.

22. If at inception, the monetary value of such an instrument is not predominantly based on a fixed monetary amount, the instrument would not be within the scope of paragraph 12 of FAS 150. Consequently, some Task Force members questioned whether paragraph 25 of the draft Status section update for Issue 98-5 went beyond providing an update for the issuance of FAS 150 and actually provided new interpretive guidance. Comments were not received from Task Force members on paragraph 24.

23. An example of a financial instrument that contains a share settlement feature with a fixed payoff, but that may not be within the scope of paragraph 12 of FAS 150, is as follows:

Company A issues a convertible debt instrument for its par amount of \$1,000 that is "convertible" at any time throughout the life of the instrument. The share price at issuance is \$50 per share. The number of shares issuable at settlement is determined by dividing \$1,000 by the lower of (a) 80 percent of the issuer's share price at the settlement date (resulting in a fixed monetary payoff of \$1,250) or (b) \$40 (resulting in a payoff that varies directly with the changes in the issuer's share price).

The following outcomes would occur under various share price scenarios:

Stock price at conversion date	25	30	40	50	60	70	80
80% of stock price at conversion date	20	24	32	40	48	56	64
Conversion Price (lesser of 80% of stock price or \$40)	20	24	32	40	40	40	40
# of shares received at conversion	50.0	41.7	31.3	25.0	25.0	25.0	25.0
Value of shares received at conversion	1,250	1,250	1,250	1,250	1,500	1,750	2,000

In this example, if the share price is between \$0.01 and \$50.00 the holder will receive a variable number of shares with a fair value of \$1,250 at settlement. Within that share price range, the payoff that the holder receives at settlement is unaffected by the issuer's share price. However, if the share price is more than \$50 upon settlement, the holder will convert into 25 shares and the payoff that the holder receives at settlement varies directly with changes in the issuer's share price.

24. As discussed above, if, at inception, the monetary value of such an instrument is not predominantly based on a fixed monetary amount, the instrument would not be within the scope of paragraph 12 of FAS 150. This Issue addresses instruments that are outside of the scope of FAS 150 and provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount, or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than a certain amount. Specifically, what constitutes a "conversion option" for purposes of applying Issues 98-5 and 00-27? In order to identify the conversion option for purposes of applying Issues 98-5 and 00-27, the unit of account for embedded features in a financial instrument must be determined.

25. The financial instrument described above can be viewed as having either (a) a single compound embedded feature (that is, one embedded feature with the characteristics of a share-settled put warrant⁴) or (b) two separate embedded features (that is, an embedded put option and an embedded conversion feature). The Task Force's decision on this question could have significant accounting consequences in the application of Issue 98-5, Issue 00-27, and FAS 133. For example, if an entity evaluated the embedded feature as a single unit of account similar to a share-settled put warrant (View B), then that feature would first be evaluated to determine whether separation is required under FAS 133. Depending on the Task Force's decisions in Issue 07-5 and application of the guidance in Issue 00-19, that single embedded feature may or may not qualify for the scope exception in paragraph 11(a) of FAS 133. If it does not qualify for the paragraph 11(a) scope exception, and the feature has all the characteristics of a derivative instrument in paragraphs 6–9 of FAS 133, then separate accounting as a derivative would be required. That might be the case if, for example, the instrument does not contain a cap on the number of shares to be delivered if the issuer's stock price is below \$50

⁴ Refer to Example 3 of FSP FAS 150-1 for an illustration of a freestanding share-settleable put warrant.

26.—at settlement.⁵ However, if the embedded feature does qualify for the paragraph 11(a) scope exception such that bifurcation is not required under FAS 133, then the feature would be evaluated under Issues 98-5 and 00-27 and, in the example above, a \$250 beneficial conversion option would be recognized (assuming the issuer's stock price was less than \$50 at the commitment date).

27. In contrast, if the convertible debt instrument in the above example were viewed as having two embedded derivatives (View A), it appears that the embedded put option would require bifurcation as a derivative pursuant to the guidance in paragraph 13(b) of FAS 133. However, that embedded conversion option is more likely to qualify for the scope exception in paragraph 11(a) of FAS 133 because (a) it has a fixed conversion price and (b) there are no circumstances in which the issuer could potentially be required to deliver an unlimited number of shares upon conversion. Additionally, the embedded conversion option would not contain a beneficial conversion feature (assuming that the issuer's stock price was less than \$50 at the commitment date).

28. It should be noted that the Task Force's decision on Issue 2 will determine the necessary amendments, if any, to Case 1(d) in Exhibit 98-5A of Issue 98-5.

View A: For a convertible instrument with terms that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than that amount, the embedded conversion option is the feature that may be exercised for a fixed number of shares. The embedded feature providing for settlement through the issuance of a variable number of shares with a fixed monetary amount would not be evaluated as a conversion option under Issues 98-5 and 00-27.

⁵ If the instrument does not contain a cap on the number of shares to be delivered, the condition in paragraphs 20-21 of Issue 00-19 would be violated. Therefore, the paragraph 11(a) scope exception would not be met due to the fact that the instrument would not be classified in equity in the statement of financial position as net-share settlement is not within the control of the company.

29. Under View A, in the above example, the financial instrument would be evaluated as having two embedded features (an embedded put option and an embedded conversion feature). As a result, the instrument would be evaluated as a convertible debt instrument with a conversion price of \$50, which is the price at which the holder begins to benefit from increases in the issuer's share price. For purposes of evaluating whether a beneficial conversion feature is present, the issuer's share price on the commitment date would be compared to the \$50 conversion price.

30. Proponents of this view believe that a provision of an instrument that would provide a fixed payoff to the holder should not be considered a conversion feature under the provisions of Issues 98-5 or 00-27. Conversely, such a provision should be evaluated as an embedded put option that must be accounted for pursuant to FAS 133 and other applicable accounting literature. The conversion option would be evaluated as the component of an instrument that provides for settlement in a fixed number of shares when the instrument is "in-the-money" (that is, when the share price exceeds \$50).

31. Additionally, proponents of View A believe that transactions that are economically similar should receive the same accounting treatment. If View A is not supported, the accounting for two similar transactions may be reported differently. For example, stock-settled debt issued for proceeds of \$1,000 that has (a) a principal amount of \$1,250, (b) an embedded put option that can be exercised at any time by the holder for the instrument's principal amount, and (c) a conversion option that entitles the holder to convert the instrument into 25 equity shares (that is, a \$50 conversion price) is economically similar to the example in paragraph 23 above. However, proponents of View A observe that there does not appear to be a basis for combining all of the explicit embedded features together for purposes of determining whether separation is required under FAS 133. Those proponents believe that the accounting for the two transactions should be the same regardless of how the terms of the instrument are described in the transaction documents (that is, whether they are described as two embedded features or as one compound embedded feature).

32. This view is further supported by language in Issue 00-27. Paragraph 13 in Issue 3 of Issue 00-27 states that,

The Task Force noted that if a convertible instrument has a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date, the convertible instrument should be considered stock-settled debt and the contingent beneficial conversion option provisions of Issue 98-5 would not apply when those resets subsequently occurred. However, Issue 98-5 would apply to the initial accounting for the convertible instrument including any initial active beneficial conversion feature. [Footnote reference omitted.]

33. View A proponents believe that the final sentence of paragraph 13 regarding "initial active beneficial conversion features" was nullified by FAS 150. Those proponents refer to the status update in paragraph 64 of Issue 00-27, which states

An instrument issued in the form of shares that is convertible into a variable number of shares based solely or predominantly on one of the conditions in paragraph 12 of Statement 150... is a liability under Statement 150, paragraph 12, because it is an outstanding share that embodies an unconditional obligation to be redeemed. **It is no longer in the scope of Issue 00-27.** [Emphasis added.]

34. Proponents of this view believe that these two sections provide guidance consistent with View A. That is, an instrument that includes a provision that requires (or permits at the issuer's discretion) settlement by issuance of a variable number of shares that have a value equal to a fixed monetary amount is not a conversion option for purposes of applying Issue 98-5.

35. Proponents of View A also refer to Example 15 in FAS 133, where a hybrid financial instrument is described as containing two embedded derivatives. Additionally, DIG Issue B15 addresses the measurement of an embedded derivative that consists of more than one embedded feature that **individually** warrant separate accounting under FAS 133. View A proponents believe that FAS 133 requires an entity to evaluate embedded derivatives separately when determining whether separation is required, so the unit of account for an embedded feature should be based on each potential payoff outcome, rather than the description of the contractual terms of the instrument. Those proponents observe that the issuer may be able to avoid

bifurcating an embedded put option that would otherwise require separate accounting as a derivative by combining that feature with the conversion option and concluding that the scope exception in paragraph 11(a) is met.

36. If View A is supported by the Task Force, the guidance in Case 1(d) in Exhibit 98-5A will be nullified because an amendment to Case 1(d) would require illustration of how FAS 133 would be applied to the fixed payoff feature (that is, the embedded put option). Guidance on the application of FAS 133 would not be appropriate in the application examples for Issue 98-5.

View B: For a convertible instrument with terms that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than that amount, the embedded conversion option is a single compound embedded feature that should be analyzed as a unit for purpose of applying Issues 98-5 and 00-27.

37. Under View B, the financial instrument in the above example has a compound embedded conversion option with a conversion price that (a) varies if settlement occurs when the issuer's share price is between \$0.01 and \$50, and (b) is fixed if settlement occurs when the issuer's share price is greater than or equal to \$50. If the conversion option contains all the characteristics of a derivative instrument in paragraphs 6–9 of FAS 133, the issuer might conclude that the conversion option is not indexed to the Company's own stock because of the continuously resetting conversion rate, in which case and separate accounting for the conversion option as a derivative would be required.⁶ However, if the conversion option does not contain all of the characteristics of a derivative instrument under FAS 133 or qualifies for the scope exception in paragraph 11(a) of that Statement, the instrument in the above example contains a beneficial conversion feature that must be allocated to additional paid-in capital under the provisions of Issue 98-5. If the issuer's share price is \$50 or less at issuance, that beneficial conversion feature would be \$250, calculated as the difference between the initial conversion

⁶ Issue 07-5 is currently on the EITF agenda and addresses the determination of whether an equity-linked financial instrument (or an embedded feature) should be considered indexed to an entity's own stock.

price and the fair value of the shares into which the debt is convertible, multiplied by the number of shares into which the debt is convertible. That amount represents the difference between the proceeds received at issuance (\$1,000) and the value of the shares issuable at conversion (\$1,250) whenever the share price is less than \$50.

38. Proponents of View B believe that the identification of the embedded conversion feature should be consistent with how that feature is characterized in the legal arrangement. Therefore, as the terms of the financial instrument described above state that the instrument is convertible into the lower of (a) 80 percent of the issuer's share price at the settlement date or (b) \$40, then the embedded conversion option should be identified consistent with that description, regardless of the economics of the transaction.

39. If View B is supported by the Task Force, the guidance in Case 1(d) in Exhibit 98-5A will be retained as that example currently reflects the guidance in View B.

Other Consideration Relating to Issue 2

40. The Task Force should consider whether Issue 2 goes beyond the scope of what was intended by the proposed draft update of the conforming changes to Issue 98-5 (included in the Proposed EITF Issue Clarification discussed at the November 29, 2007 EITF meeting) and the recommendation by the Agenda Committee to address this specific issue. After further research of this issue, it has become clear that the guidance on what constitutes a "conversion option" for financial instruments that have terms that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than a certain amount, may have a significant impact on other transactions that are within the scope of FAS 133. Some believe that the Task Force should not provide narrow interpretive guidance relating to the unit of account for embedded features in a particular type of convertible debt instruments that appear to be somewhat uncommon in practice. While it is acknowledged that there is diversity in defining the unit of account for embedded features in general, the Task Force should consider whether guidance should be provided in the narrow context of beneficial conversion features for one particular type of

instrument. For example, the determination of a unit of account for embedded features under FAS 133 requires judgment in many circumstances. Additionally, there is concern that if guidance regarding the unit of account for an embedded feature is provided for in the context of the financial instrument discussed herein, inappropriate analogies to other financial instruments may occur in practice without the Task Force's specific consideration. At a minimum, if the Task Force proceeds with issuing guidance, the staff recommends that any such guidance should preclude analogies and apply only to financial instruments that have terms that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than a certain amount.

41. It should be noted that if the Task Force chooses to not provide guidance on Issue 2, the guidance in Case 1(d) in Exhibit 98-5A will be nullified.

Transition and Effective Date

42. This Issue should be effective for fiscal years beginning after December 15, 2008. The staff has identified the following transition alternatives for Task Force consideration:

Alternative A: Entities should recognize the effect of the consensus as a change in accounting principle through retrospective application to all prior periods for financial instruments within the scope of Issue 2⁷ with a commitment date prior to the effective date. Entities should disclose the cumulative-effect of the change on retained earnings in the statement of financial position as of the beginning of the first period presented.

Alternative B: Entities should recognize the effect of the consensus as a change in accounting principle as of the beginning of the fiscal year in which this consensus is initially applied for financial instruments within the scope of Issue 2 with a commitment date prior to the effective

⁷ Applicable financial instruments are convertible instruments that provide for settlement through the issuance of (a) a variable number of shares with a fixed monetary amount if settlement occurs when the share price is less than a certain amount, or (b) a fixed number of shares if settlement occurs when the share price is equal to or greater than a certain amount.

date. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings for that fiscal year, presented separately.

Alternative C: Entities should recognize the effect of the consensus on a prospective basis to financial instruments within the scope of Issue 2 entered into subsequent to the effective date.

43. The staff considers Alternative A to be consistent with paragraph 7 of FAS 154, which requires retrospective application for changes in accounting principles. In addition, retrospective application is the transition method that best achieves consistency of financial information between periods and facilitates comparability of accounting data. If it is impracticable to apply retrospective application, paragraph 9 of FAS 154 allows for the new accounting principle to be applied on an alternative basis.

44. Alternative B carries the benefit of consistency and comparability for the current year and future years without the burden of recasting prior years' amounts. Alternative B requires entities to evaluate only the arrangements in effect at the effective date of this Issue. The staff acknowledges that with the reduced burden of Alternative B comes less consistency and comparability for years prior to the year of adoption.

45. Alternative C would eliminate the need to reassess transactions entered into prior to the effective date. Opponents of Alternative C are concerned with the inconsistency that results from allowing transactions entered into prior to the effective date of this Issue to be accounted for in a manner inconsistent with the consensus reached.

Appendix 98-5A

PROPOSED MODIFICATIONS TO ISSUE 98-5

Background

1. Issue 98-5 addresses (a) the accounting for convertible debt instruments and convertible preferred stock with nondetachable conversion features that are in-the-money at the commitment date and (b) an issuer's accounting for convertible instruments that have conversion prices that are variable based on future events. Issue 98-5 is applicable to instruments issued after May 20, 1999. Subsequent to the issuance of this consensus, a number of issues about the application of the Issue 98-5 model arose.

2. Issue 00-27 was issued by the Task Force to address such application issues. The consensus reached for Issues 2-8, 10, and 11 are applicable to instruments issued after November 16, 2000, for which a commitment date, as defined by Issue 98-5, has not occurred prior to November 16, 2000. However, Issue 1 of Issue 00-27 is applicable to all transactions subject to Issue 98-5, including those transactions for which a commitment date occurred before November 16, 2000.

3. In reaching the consensus on Issue 00-27, the Task Force modified portions of Issue 98-5. Specifically,
 - Issue 4, paragraphs 16 and 17, of Part II of Issue 00-27 replaces the definition of commitment date in footnote 1 of Issue 98-5 with a definition that is consistent with the firm commitment definition in FAS 133.

 - Issue 6 of Part II of Issue 00-27 modifies the model in Issue 98-5 for convertible instruments that have a stated redemption date to require a discount resulting from recording a beneficial conversion option to be amortized from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs. The Task Force also modified Issue 98-5 for circumstances in which the instrument is converted prior to amortization of the full amount of the discount.

Issue 00-27 requires that the unamortized discount remaining at the date of conversion be immediately recognized as interest expense or as a dividend, as appropriate.

4. Such modifications were not clearly reflected in Issue 98-5 leaving inconsistencies between Issue 98-5 and Issue 00-27. As such, the staff has prepared Exhibit 00-27B (which is included below in this appendix) to reflect the modification to Issue 98-5 resulting from the consensus in Issue 00-27. As requested by the Task Force, this format will retain the historical information from Issue 98-5 while providing constituents with the current authoritative accounting literature.

5. In addition to retaining the historical accounting literature, the FASB staff has created a bridge between the modified language in Issue 98-5 and the proposed Exhibit 00-27B, which illustrates the modifications. For all modifications to Issue 98-5, the following statement will be inserted after the modified language:

[This consensus has been modified by Issue 00-27. See paragraph 17A – 18C of the STATUS section.]

The Status section of Issue 98-5 will then provide information regarding the issuance of Issue 00-27 as well as reference to Exhibit 00-27B, which will illustrate the modifications to Issue 98-5, thereby retaining the historical literature. The staff suggests this format of modification to Issue 98-5 as it is consistent with modifications made to other forms of authoritative accounting literature and retains the historical information from Issue 98-5, as requested by the Task Force.

6. Additionally, FAS 150 was issued in May 2003 and is effective for financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the first interim period beginning after June 15, 2003. Instruments within the scope of FAS 150 are accounted for pursuant to the guidance in that Statement and are not within the scope of Issues 98-5 and 00-27. However, discussion of FAS 150 was not included in the Status section of Issue 98-5.

Status Section Update for Issue 98-5

7. The Status section of Issue 98-5 will be updated to include the following relating to Issue 00-27 [Added text is underlined and deleted text is ~~struck out~~.]:

18. Issue No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments,” addresses a number of practice issues raised about the application of the Issue 98-5 model. The Task Force reached a consensus on Issue 00-27 at the November 15–16, 2000 meeting. For instruments issued after November 16, 2000, for which a commitment date, as originally defined in Issue 98-5, has not occurred prior to November 16, 2000, the consensuses in Issue 00-27 should be applied. Issue 98-5 originally defined a commitment date as the date when an agreement as to terms has been reached and the investor is committed to purchase the convertible securities based on those terms (that is, performance by the investor is probable because of sufficiently large disincentives for nonperformance). In certain cases, the securities may be purchased by a number of investors, such as a group of lenders participating in a syndicate. In those situations, the latest commitment date for the group or issuance date for each individual security, whichever comes first, should be considered the commitment date.

18A. During the discussions of Issue 00-27, the SEC Observer stated that the consensus on Issue 1 of Part II of Issue 00-27 must be applied to all transactions subject to Issue 98-5, including those transactions for which a commitment date occurred before November 16, 2000. The effect, if any, of initial application of the consensus on Issue 1 of Part II to all prior transactions (including existing, terminated, and converted) subject to Issue 98-5 should be reported as of the beginning of a registrant’s quarter that includes the date of the Issue 00-27 consensus (November 16, 2000) in a manner similar to the cumulative effect of a change in accounting principle in accordance with Opinion 20.

18B. Cases 1(a), 1(b), 2, 3, 4, and 6 in Exhibit 98-5A, *Examples of Application of the EITF Consensuses on Issue 98-5*, have been modified to reflect the guidance provided for in Issue 00-27.

18C. Refer to Exhibit 00-27B of Issue 00-27 for an illustration of the modifications to Issue 98-5 by Issue 00-27.

8. Additionally, the Status section of Issue 98-5 will also include the following relating to FAS 150:

19A. Statement 150 was issued in May 2003 and is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the interim period beginning after June 15, 2004, except for mandatorily redeemable financial instruments of a nonpublic entity. Statement 150 establishes standards for issuer’s classification and measurement of certain financial instruments with

characteristics of both liabilities and equity, and requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances).

19B. Cases 1(c) and 5 in Exhibit 98-5A, *Examples of Application of the EITF Consensuses on Issue 98-5*, have been deleted as the instruments described in those examples are within the scope of Statement 150.

Proposed Exhibit 00-27B

ILLUSTRATION OF THE MODIFICATIONS TO ISSUE 98-5 BY ISSUE 00-27

1. This exhibit illustrates the modifications to Issue 98-5 resulting from the consensus in Issue 00-27 as follows:

EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios*, is modified as follows: [Added text is underlined and deleted text is ~~struck-out~~.]

- a. Footnote 1 to paragraph 1:

~~The commitment date is the date when an agreement as to terms has been reached and the investor is committed to purchase the convertible securities based on those terms (that is, performance by the investor is probable because of sufficiently large disincentives for nonperformance). In certain cases, the securities may be purchased by a number of investors, such as a group of lenders participating in a syndicate. In those situations, the latest commitment date for the group or issuance date for each individual security, whichever comes first, should be considered the commitment date.~~

The commitment date is defined as an agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

- a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.

- b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large

disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

The Task Force observed that if an agreement includes subjective provisions that permit either party to rescind its commitment to consummate the transaction (for example, a provision that allows an investor to rescind its commitment to purchase a convertible instrument in the event of a material adverse change in the issuer's operations or financial condition or a provision that makes the commitment subject to customary due diligence or shareholder approval), a commitment date should not occur until the provisions expire or the convertible instrument is issued, whichever is earlier.

b. Paragraph 6:

The Task Force observed that in certain circumstances, the intrinsic value of the beneficial conversion feature may be greater than the proceeds allocated to the convertible instrument. In those situations, the Task Force reached a consensus that the amount of the discount assigned to the beneficial conversion feature is limited to the amount of the proceeds allocated to the convertible instrument. ~~Except as provided in paragraph 10 below, the discount assigned to the convertible instrument, if any, should be amortized over the period to the security's earliest conversion date.~~ For convertible instruments that have a stated redemption date, a discount resulting from recording a beneficial conversion option shall be required to be amortized from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs. For convertible instruments that do **not** have a stated redemption date, such as perpetual preferred stock, a discount resulting from the accounting for a beneficial conversion option shall be amortized from the date of issuance to the earliest conversion date.

c. Paragraph 8 and its related footnote 5:

~~For convertible preferred securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature is analogous to a dividend and should be recognized as a return to the preferred shareholders over the minimum period from the date of issuance to the date at which the preferred shareholders can realize that return (that is, through the date of earliest conversion)⁵ using the effective yield method.~~ For convertible preferred securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature is analogous to a dividend and should be recognized as a return to the preferred shareholders using the effective yield method.

⁵~~For those preferred securities that are convertible at the date of issuance, the Task Force observed that the discount would be fully amortized through retained earnings at the date of issuance.~~

d. Paragraph 9 and its related footnote 6:

~~For convertible debt securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature should be recognized as interest expense over the minimum period from the date of issuance to the date at which the debtholder can realize that return (that is, through the date of earliest conversion⁶) using the effective yield method. For convertible debt securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature should be recognized as interest expense using the effective yield method.~~

⁶For those debt securities that are convertible at the date of issuance, the Task Force observed that the discount would be fully amortized through interest expense at the date of issuance.

e. Paragraph 10:

In situations in which the instrument incorporates a multiple-step discount (for example, an instrument that provides for a 15 percent discount to the market price after 3 months, a 25 percent discount after 6 months, a 35 percent discount after 9 months, and a 40 percent discount after 1 year), the basic accounting model described above is modified. For those types of convertible securities, the Task Force reached a consensus that the computation of the intrinsic value should be made using the conversion terms that are most beneficial to the investor. If the convertible instrument has a stated redemption date, the resultant discount should be amortized from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs (in the example noted above, the discount would be 40 percent and the amortization period would be from issuance to the stated redemption date).

~~The resultant discount should be~~ For convertible instruments that do **not** have a stated redemption date, the resultant discount should be amortized over the minimum period in which the investor can recognize that return (in the example noted above, the discount would be 40 percent and the amortization period would be 1 year). However, amortization recognized may require adjustment to ensure that the discount amortized at any point in time is not less than the amount the holder of the instrument could obtain if conversion occurred at that date. That is, at the end of 3 months, at least the 15 percent discount should have been recognized. This method can be expressed as requiring cumulative amortization equal to the *greater of* (a) the amount derived using the effective yield method based on the conversion terms most beneficial to the investor or (b) the amount of discount which the investor can realize at that interim date.

f. Paragraph 11:

~~In circumstances in which the instrument is converted prior to amortization of the full amount of the discount, the remaining unamortized discount should be included in the carrying value of the convertible security that is transferred to equity at the date of conversion.~~ In circumstances in which the instrument is converted prior to amortization of the full amount of the discount, the remaining unamortized discount at the date of conversion should be immediately recognized as interest expense or as a dividend, as appropriate.^{6A} If the amount of unamortized discount is recognized as an expense (because the convertible instrument was in debt form), the expense should not be classified as extraordinary. If, however, the amount of discount amortized exceeds the amount the holder realized because conversion occurred at an earlier date, the Task Force agreed that no adjustment should be made to amounts previously amortized.

^{6A} For convertible debt that does not include a beneficial conversion option, Accounting Interpretation 1 of Opinion 26 and Issue No. 85-17, "Accrued Interest upon Conversion of Convertible Debt," continue to apply. Those pronouncements state that the net carrying amount of the convertible debt, including any unamortized premium or discount, is credited to equity upon conversion.

g. Paragraph 13:

The Task Force also discussed the accounting for (a) a security that becomes convertible only upon the occurrence of a future event outside the control of the holder and (b) a security that is convertible from inception but contains conversion terms that change upon the occurrence of a future event. The Task Force reached a consensus that any contingent beneficial conversion feature should be measured ~~at~~ using the commitment date stock price but not recognized in earnings until the contingency is resolved.

h. Paragraph 17A is added as follows:

Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," addresses a number of practice issues raised about the application of the Issue 98-5 model. The Task Force reached a consensus on Issue 00-27 at the November 15–16, 2000 meeting.

i. Paragraph 18:

For instruments issued after November 16, 2000, for which a commitment date, as originally defined in Issue 98-5, has not occurred prior to November 16, 2000, the consensus in Issue 00-27 should be applied. Issue 98-5 originally defined a commitment date as the date when an agreement as to terms has been reached and the investor is committed to purchase the

convertible securities based on those terms (that is, performance by the investor is probable because of sufficiently large disincentives for nonperformance). In certain cases, the securities may be purchased by a number of investors, such as a group of lenders participating in a syndicate. In those situations, the latest commitment date for the group or issuance date for each individual security, whichever comes first, should be considered the commitment date.

j. Paragraphs 18B and 18C are added as follows:

18B. Cases 1(a), 1(b), 2, 3, 4, and 6 in Exhibit 98-5A, *Examples of Application of the EITF Consensuses on Issue 98-5*, have been modified to reflect the guidance provided for in Issue 00-27.

18C. Refer to Exhibit 00-27B for marked modifications to Issue 98-5.

k. Exhibit 98-5A, Case 1(a):

Assumptions:

1. \$1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible at date of issuance.
3. Convertible at \$40 per share.
4. Fair value (FV) of common at commitment date equals \$50 per share.

Calculation:

FV at commitment date	\$50
Conversion price (stated and will not change)	\$40
Intrinsic value of beneficial conversion feature	\$250,000 ⁷
Amount to record at date of issuance	\$250,000

The beneficial conversion feature is calculated at its intrinsic value (that is, the difference between the conversion price and the fair value of the common stock into which the debt is convertible, multiplied by the number of shares into which the debt is convertible) at the commitment date. A portion of the proceeds from issuance of the convertible debt, equal to the intrinsic value, is then allocated to additional paid-in capital (APIC). ~~Because the debt is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance.~~ Because the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

m. Exhibit 98-5A, Case 2:

Assumptions:

1. \$1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible upon an initial public offering (IPO).
3. Convertible at 80 percent of stock price at commitment date (that is, \$40).
4. FV of common at commitment date equals \$50 per share.

Calculation:

IPO price	<u>\$50</u>	<u>\$60</u>	<u>\$70</u>
Stock price at commitment date	\$50	\$50	\$50
80% of stock price at commitment date	\$40	\$40	\$40
Intrinsic value of beneficial conversion feature at commitment date	\$250,000 ¹⁵	\$250,000 ¹⁶	\$250,000 ¹⁷

The instrument is not convertible at the commitment date; however, it will become convertible and that conversion feature will be beneficial if an IPO is completed. The intrinsic value of the beneficial conversion feature is calculated at the commitment date using the stock price as of that date, that is, \$250,000. However, that amount would only be recorded at the date an IPO is completed. If the IPO were completed on the third anniversary of the debt issuance, the discount amount would be recorded at that date and amortized over a two-year period ending on the stated redemption date of the debt.

Entry at issuance:

Cash	\$1,000,000	
Debt		\$1,000,000

Entry at IPO:

Debt discount Interest Expense	\$250,000	
APIC		\$250,000

¹⁵ $(1,000,000 \div 40) \times (50 - 40)$

¹⁶ $(1,000,000 \div 40) \times (50 - 40)$

¹⁷ $(1,000,000 \div 40) \times (50 - 40)$

n. Exhibit 98-5A, Case 3:

Assumptions:

1. \$1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible at date of issuance.
3. Convertible at 80 percent of stock price at commitment date (that is, \$40).
4. FV of common at commitment date equals \$50 per share.
5. If there is an IPO, the conversion feature adjusts to the lesser of \$30 or 80 percent of the IPO price.

Calculation:

FV at commitment date	\$50
<u>Conversion price at commitment date</u>	<u>\$40</u>
Intrinsic value of basic beneficial conversion feature <u>at commitment date</u>	<u>\$250,000¹⁸</u>
<u>Conversion price at contingency resolution</u>	<u>unknown</u>
Most beneficial conversion price at commitment date	\$30
Intrinsic value of contingent beneficial conversion feature at commitment date	unknown \$666,667 ¹⁹
Amount recorded at issuance date	250,000
Additional intrinsic value of contingent beneficial conversion feature at commitment date	\$416,667

This instrument includes a “basic” beneficial conversion feature that is not contingent upon the occurrence of a future event and a contingent beneficial conversion feature. Accordingly, the intrinsic value of the basic beneficial conversion feature of \$250,000 is calculated at the commitment date and recorded at the issuance date. ~~Because the debt is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance. Because the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.~~

~~The amount of the contingent beneficial conversion feature also is calculated at the commitment date using the terms most advantageous to the investor, based on the facts available at that date. In this instance, the most beneficial conversion price at the commitment date is \$30 per share. Accordingly, the beneficial conversion feature is calculated using the \$30 per share conversion price resulting in a contingent beneficial conversion amount of \$666,667. However, the amount in excess of the \$250,000 previously recognized would not be recorded until the IPO occurs.~~

Entry at date of issuance:

Cash	\$1,000,000	
Debt discount Interest expense	250,000	
Debt		\$1,000,000
APIC		250,000

~~Subsequent entry (assuming IPO occurs):~~

Interest expense	\$416,667	
APIC		\$416,667

The terms of the convertible debt instrument do not permit the number of shares that would be received upon conversion if an IPO occurs to be calculated at the commitment date. Refer to Issues 3 and 7 of Issue 00-27 for guidance on recognition and measurement of the contingent beneficial conversion feature.

$$^{18}(1,000,000 \div 40) \times (50 - 40)$$

$$^{19}(1,000,000 \div 30) \times (50 - 30)$$

o. Exhibit 98-5A, Case 4:

Assumptions:

1. \$1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance.
2. Convertible at date of issuance.
3. Convertible at 80 percent of stock price at commitment date (that is, \$40).
4. FV of common at commitment date equals \$50 per share.
5. If the stock price increases at least 15 percent one year after an IPO, the conversion feature adjusts to 65 percent of the fair value of the common stock one year after the IPO.

Calculation:

FV at commitment date	\$50
Conversion price at commitment date	\$40
Conversion price at contingency resolution	<u>unknown</u> \$37.38 ²⁰
Intrinsic value of basic beneficial conversion feature	
at commitment date	\$250,000 ²¹
Intrinsic value of contingent beneficial conversion feature	
at commitment date	<u>unknown</u> \$538,256 ²²

The amount of the beneficial conversion feature is measured using the terms of the beneficial conversion feature that are operative at issuance, that is, the 20 percent discount. The intrinsic value of that beneficial conversion feature

~~(\$250,000) is calculated at the commitment date and recorded at the issuance date. Because the debt is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance. Because the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.~~

~~Because this instrument also contains a contingent beneficial conversion feature, that amount also should be calculated at the commitment date assuming that an IPO will occur in the future and the company's stock appreciates by the requisite percentage using facts available at the commitment date. Accordingly, the conversion price is calculated assuming that (a) the IPO price is the stock price at the commitment date and (b) the targeted stock appreciation is achieved. However, an additional amount, representing the intrinsic value of the "contingent" beneficial conversion feature (\$288,256),²³ would only be recorded once the IPO has been completed and the targeted stock price has been achieved 1 year later.~~

Entry at date of issuance:

Cash	\$1,000,000	
Debt discount Interest expense	250,000	
Debt		\$1,000,000
APIC		250,000

~~Subsequent entry (assuming IPO occurs and targeted stock price is achieved):~~

~~Subsequent entry (assuming IPO occurs):~~

Interest expense	\$288,256	
 APIC		\$288,256

The terms of the convertible debt instrument do not permit the number of shares that would be received upon conversion if an IPO occurs to be calculated at the commitment date. Refer to Issues 3 and 7 of Issue 00-27 for guidance on recognition and measurement of the contingent beneficial conversion feature.

²⁰~~(50 x 115%) x 65%~~

²¹~~(1,000,000 ÷ 40) x (50 - 40)~~

²²~~(1,000,000 ÷ 37.38) x (57.50 - 37.38)~~

²³~~\$538,256 - \$250,000~~

p. Exhibit 98-5A, Case 6:

At the commitment date:

Proceeds from issuance of zero coupon convertible debt \$100

Intrinsic value of beneficial conversion feature \$90

At the commitment date, the issuer records \$90 as discount on the debt with the offsetting entry to additional paid-in capital. The remainder (\$10) is recorded as debt and is accreted to its full face value of \$100 over the period from the issuance date until the stated redemption date of the instrument (three years)earliest conversion date. The debt is subsequently extinguished one year after issuance.

At the extinguishment date:

Reacquisition price	\$150
Intrinsic value of beneficial conversion feature at extinguishment date	\$80
Carrying value of debt	<u>\$22²⁵100</u>

At the date of extinguishment, the extinguishment proceeds should first be allocated to the beneficial conversion feature (\$80 as noted above). The remainder (\$70) is allocated to the extinguishment of the convertible security.

Entry to record the extinguishment:

Cash	\$1,000,000	
<u>Debt discount</u> Interest expense	250,000	
Debt		\$1,000,000
APIC		250,000
Debt	\$ <u>22100</u>	
Equity (paid-in capital)	80	
<u>Loss on extinguishment</u>	48	
Gain on extinguishment		\$ 30
Cash		150

²⁵The net carrying value of the debt one year after issuance is calculated using the effective interest method to amortize the debt discount over three years.