FASB Emerging Issues Task Force

Issue No. 07-2

Title: Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement upon Conversion

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Previously distributed EITF materials: None

References:

FASB Statement No. 84, Induced Conversions of Convertible Debt (FAS 84)

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

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 Statement No. 155, Accounting for Certain Hybrid Financial Instruments (FAS 155)

FASB Discussion Memorandum, Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both (Discussion Memorandum on liability and equity instruments)

APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants (APB 14)

* The alternative views presented in this Issue Summary 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.
APB Opinion No. 21, *Interest on Receivables and Payables* (APB 21)


EITF Issue No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion" (Issue 90-19)

EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments" (Issue 96-19)

EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" (Issue 98-5)

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

EITF Issue No. 03-7, "Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)" (Issue 03-7)

EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share" (Issue 04-8)

EITF Issue No. 05-1, "Accounting for the Conversion of an Instrument That Became Convertible upon Issuer's Exercise of a Call Option" (Issue 05-1)

EITF Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in Issue No. 00-19" (Issue 05-2)

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

EITF Issue No. 06-7, "Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133" (Issue 06-7)

*EITF Abstracts*, Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share" (Topic D-72)
Background

1. At the September 7, 2006 EITF meeting, the Task Force recommended that the Board consider adding a short-term project to its agenda to address the accounting for convertible debt instruments separately from its liabilities and equity project. At its January 3, 2007 meeting, the Board decided not to undertake a short-term project to amend the guidance in APB 14 on the accounting for convertible debt instruments, but to pursue a more aggressive timeline for the modified joint liabilities and equity project. The applicability of APB 14 to convertible debt instruments that require or permit partial cash settlement upon conversion was not addressed in connection with those deliberations.

2. Issue 90-19 provides accounting and earnings-per-share guidance for three types of structured convertible debt instruments. One of the instruments within the scope of that Issue, referred to as "Instrument C," is described as follows:

   Instrument C: Upon conversion, the issuer must satisfy the accreted value of the obligation (the amount accrued to the benefit of the holder exclusive of the conversion spread) in cash and may satisfy the conversion spread (the excess conversion value over the accreted value) in either cash or stock.

3. At the May 9, 1991 EITF meeting, the Task Force reached a consensus that Instrument C should be accounted for as indexed debt, rather than convertible debt. Under that original consensus, an issuer was required to adjust the carrying amount of the instrument in each reporting period to reflect the current stock price, but not below the accreted value of the instrument, with the related change in the carrying amount recognized in earnings. At the January 23–24, 2002 EITF meeting, the Task Force revised the original consensus in Issue 90-19 to specify that Instrument C should be accounted for like convertible debt (that is, as a combined instrument) if the conversion spread meets the requirements of Issue 00-19.

4. The Task Force also reached a consensus at the January 23–24, 2002 EITF meeting to revise the diluted earnings-per-share guidance in Issue 90-19 to specify that the if-converted method should not be used to determine the earnings-per-share implications of Instrument C. Instead, there would be no adjustment to the numerator in the earnings-per-share computation for the
cash-settled portion of Instrument C because that portion of the instrument will always be settled in cash. The conversion spread should be included in diluted earnings per share based on the provisions of paragraph 29 of FAS 128 and Topic D-72.

5. At the July 31, 2003 EITF meeting, the Task Force reached a consensus on Issue 03-7 that upon settlement of a security with the characteristics of Instrument C in Issue 90-19 by payment of the accreted value of the obligation (recognized liability) in cash and settlement of the conversion spread (unrecognized equity instrument) with stock, only the cash payment should be considered in the computation of gain or loss on extinguishment of the recognized liability. That is, any shares transferred to settle the embedded equity instrument (referred to as the conversion spread in Issue 90-19) would not be considered in the settlement of the debt component.

6. Issuances of convertible debt instruments with the characteristics of Instrument C have proliferated in the marketplace since the revision of Issue 90-19 and the consensus in Issue 03-7. Additionally, issuances of convertible debt instruments with the characteristics of Instrument C became even more prevalent after Issue 04-8 eliminated the diluted earnings-per-share benefits associated with contingently convertible instruments ("Co-Cos") that contain a market price trigger. Prior to the effective date of Issue 04-8, a number of issuers amended the terms of their Co-Cos to incorporate the characteristics of Instrument C. Such amendments enabled those issuers to continue to avail themselves of favorable diluted earnings-per-share treatment after adoption of Issue 04-8.1

7. Some entities have issued instruments with characteristics similar to Instrument C and have analogized to the guidance in Issue 90-19, as revised, to determine the appropriate accounting and earnings-per-share guidance. One such instrument, which was referred to as "Instrument X" in a speech given by an SEC staff member, provides the issuer with the ability to settle investor conversions in any combination of shares and cash.2 However, to achieve the same diluted-earnings-per-share treatment as Instrument C, entities that issue Instrument X adopt a stated policy of settling the debt instrument's principal amount in cash upon conversion and assert that

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1 Paragraph 9 of Issue 04-8 permitted entities that modified Co-Cos prior to the effective date of that consensus to retrospectively apply that consensus as if the modified terms had been in effect in prior periods.
this policy election overcomes the presumption of share settlement for earnings-per-share purposes pursuant to the guidance in paragraph 29 of FAS 128.

8. The revised consensus in Issue 90-19 from the January 23–24, 2002 EITF meeting requires that Instrument C be treated as convertible debt for accounting purposes but prescribes a diluted earnings-per-share methodology that is consistent with debt issued with detachable warrants. As a result, Instrument C generally has less of a dilutive impact in the calculation of diluted earnings per share than a convertible debt instrument that requires application of the if-converted method. Prior to that consensus revision, convertible debt instruments that required or permitted cash settlement upon conversion were relatively uncommon. After observing the proliferation of such instruments in the marketplace over the past several years since the consensus in Issue 90-19 was revised, questions have been raised as to whether the accounting guidance in Issue 90-19, as revised, appropriately reflects the economics of those instruments. This Issue addresses whether convertible debt instruments that require or permit partial cash settlement upon conversion are within the scope of APB 14 and would provide guidance on the appropriate accounting for such instruments if the Task Force reaches a consensus that APB 14 does not apply.

Earnings per Share

9. Neither of the alternative views described below would affect the existing guidance in FAS 128 or its related interpretations (including the earnings-per-share guidance in Issue 90-19) on calculating basic and diluted earnings per share. However, if the Task Force reaches a consensus on View B, an issuer of a convertible debt instrument that requires or permits partial cash settlement upon conversion would report lower earnings per share as a consequence of recognizing increased interest expense.

Scope

10. This Issue applies to all convertible debt instruments that require or permit partial cash settlement upon conversion if the embedded conversion option is not required to be separately accounted for as a derivative under FAS 133. Convertible preferred shares that are accounted for as mandatorily redeemable financial instruments under FAS 150 shall be considered convertible debt instruments for purposes of determining whether those instruments are within the scope of
this Issue. For example, convertible preferred shares that have a stated redemption date and also would require the issuer to settle the face amount of the instrument in cash upon exercise of the conversion option are mandatorily redeemable financial instruments under FAS 150 because they embody an unconditional obligation to redeem the instrument by transferring assets at a specified or determinable date (or dates).

11. Convertible preferred shares that are accounted for in equity (or temporary equity) are not within the scope of this Issue. For example, convertible preferred shares that have a stated redemption date and permit the issuer to settle investor conversions in any combination of shares and cash are not mandatorily redeemable financial instruments under FAS 150 because the entire instrument may be settled in a fixed number of shares (that is, redemption by transferring assets is not unconditional).

**Accounting Issue and Alternatives**

**How a company should account for a convertible debt instrument that requires or permits partial cash settlement upon conversion if, at issuance, the embedded conversion option is not required to be separately accounted for as a derivative under FAS 133.**

*View A:* A company should account for convertible debt instruments that require or permit partial cash settlement upon conversion in the same manner as other convertible debt instruments pursuant to the guidance in APB 14 and its related interpretations. This view is consistent with the existing consensus in Issue 90-19, as revised, on the accounting for Instrument C.

12. View A proponents believe that convertible debt instruments that require or permit partial cash settlement upon conversion are within the scope of APB 14 and its related interpretations (including Issues 98-5 and 00-27) when the embedded conversion option is not separately accounted for as a derivative instrument under FAS 133. As such, View A proponents believe the existing guidance on the accounting for Instrument C in Issue 90-19, as revised, should be retained.
13. Proponents of View A observe that the monetary value of the consideration received by the holder upon conversion is the same regardless of whether (a) a convertible instrument is physically settled in shares or (b) the principal amount of a convertible instrument is paid in cash and the embedded conversion option is net-share settled. Accordingly, they believe that a convertible instrument that requires or permits partial cash settlement upon conversion should be accounted for in the same manner as other convertible debt instruments. Paragraph 3 of APB 14 describes the convertible debt instruments subject to that Opinion as follows:

Convertible debt securities discussed herein are those debt securities which are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price or have a value at issuance not significantly in excess of the face amount. The terms of such securities generally include (1) an interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater than the market value of the common stock at the time of issuance, and (3) a conversion price which does not decrease except pursuant to antidilution provisions. In most cases such securities also are callable at the option of the issuer and are subordinated to nonconvertible debt.

14. View A proponents observe that convertible debt instruments that require or permit partial cash settlement upon conversion typically have (a) an interest rate that is lower than the issuer could establish for nonconvertible debt and (b) an initial conversion price that is greater than the market value of the common stock at the time of issuance, so the first two characteristics of a convertible debt instrument described in paragraph 3 of APB 14 are met. convertible debt instruments, including those that require or permit partial cash settlement upon conversion, frequently contain adjustment features that increase the number of shares issuable upon conversion (thereby decreasing the conversion price) if, within a specified time period, (a) the issuer exercises a call option on the debt or (b) there is a change in control over the issuer. However, View A proponents do not believe that such conversion price adjustment provisions impact the determination of whether convertible debt instruments, including those that require or permit partial cash settlement upon conversion, are within the scope of APB 14. Those proponents observe that Issues 98-5 and 00-27 contain guidance on accounting for convertible

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3 Such conversion price adjustment features are frequently characterized as "make-whole provisions" in the related convertible debt agreements.
instruments with contingently adjustable conversion options and those Issues do not affect the
guidance in APB 14 when a beneficial conversion feature is not present.

15. Some proponents of View A believe that FAS 133 does not permit an issuer to separately
account for an embedded conversion option in circumstances in which bifurcation is not required
under that Statement. Those proponents refer to the following discussion contained in paragraph
199 of FAS 133 (Example 33: Convertible Debt):

The issuer's accounting depends on whether a separate instrument with the
same terms as the embedded [conversion] option would be a derivative instrument
pursuant to paragraphs 6–11 of this Statement. Because the option is indexed to
the issuer's own stock and a separate instrument with the same terms would be
classified in stockholders' equity in the statement of financial position, the
[conversion] option is not considered to be a derivative instrument for the issuer
under paragraph 11(a) and should not be separated from the host contract.

16. Opponents of View A believe that the above guidance in FAS 133 only addresses whether a
conversion option is required to be separately accounted for as a derivative. Those opponents
observe that there are numerous circumstances in which an embedded conversion option that is
not currently accounted for as a derivative instrument is required to be recorded in equity under
U.S. GAAP. Those circumstances, which contain differing measurement attributes for the
conversion option, are set forth in Issues 98-5, 00-27, 06-6, and 06-7, and in paragraph 18 of
APB 14.

17. Some View A proponents believe that there are practical difficulties associated with
separating convertible debt instruments into liability and equity components. Additionally,
proponents of View A observe that the existing accounting literature applicable to financial
instruments with characteristics of liabilities and equity is complex and difficult to apply, so they
oppose creating new accounting requirements for convertible debt instruments with certain
characteristics. Those proponents believe a requirement to separate convertible debt instruments
that require or permit partial cash settlement upon conversion into their liability and equity
components would add complexity to U.S. GAAP. Accordingly, those proponents believe that
the guidance in Issue 90-19, as revised, should not be further revised until a final standard is issued through the Board's liabilities and equity project.

**View B:** *APB 14 does not provide guidance on accounting for convertible debt instruments that require or permit partial cash settlement upon conversion; therefore, a company should separately account for the liability and equity components of such instruments in a manner that reflects the company's economic interest cost. (A detailed description of the accounting treatment under View B is described in Exhibit 07-2A.)*

18. Proponents of View B refer to the following discussion in APB 14:

7. The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. **Furthermore the two choices are mutually exclusive; they cannot both be consummated.** Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he forgoes the right to redemption, and vice versa. [Emphasis added.]

12. The Board is of the opinion that no portion of the proceeds from the issuance of the types of convertible debt securities described in paragraph 3 should be accounted for as attributable to the conversion feature. **In reaching this conclusion, the Board places greater weight on the inseparability of the debt and the conversion option (as described in paragraph 7) and less weight on the practical difficulties.** [Emphasis added.]

18. The Board recognizes that it is not practicable in this Opinion to discuss all possible types of debt with conversion features, debt issued with stock purchase warrants, or debt securities with a combination of such features. **Securities not explicitly discussed in this Opinion should be dealt with in accordance with the substance of the transaction.** For example, when convertible debt is issued at a substantial premium, there is a presumption that such premium represents paid-in capital. [Emphasis added.]

19. View B proponents observe that the conclusion in APB 14 on the accounting for convertible debt was based on the inseparability of the debt and the conversion option such that the holder cannot exercise the option to convert into equity shares unless the holder forgoes the right to
repayment of the debt component. They further believe that that rationale is not applicable to convertible debt instruments that require or permit partial cash settlement upon conversion because the holder may receive both repayment of the debt instrument and net-share settlement of the conversion option (that is, the settlement outcomes are not mutually exclusive). Accordingly, View B proponents believe that issuers of convertible debt instruments that require or permit partial cash settlement upon conversion should present the liability and equity components separately on the balance sheet. Additionally, proponents of View B observe that the diluted earnings-per-share treatment specified in Issue 90-19 for Instrument C is a treasury-stock-type method that is consistent with the diluted earnings-per-share treatment of debt issued with detachable warrants. Consequently, the consensus in Issue 90-19 requires that Instrument C be treated like convertible debt for accounting purposes but prescribes a diluted earnings-per-share methodology that is consistent with debt issued with detachable warrants.

20. View B proponents believe that the Accounting Principles Board did not consider convertible debt instruments that require or permit partial cash settlement upon conversion when APB 14 was issued in 1969. Those proponents observe that APB 14 specifies that "securities not explicitly discussed in this Opinion should be dealt with in accordance with the substance of the transaction." View B proponents also observe that the Task Force originally concluded in Issue 90-19 that convertible debt with the characteristics of Instrument C should be accounted for as indexed debt, rather than convertible debt under APB 14. Consistent with the Task Force's original consensus in Issue 90-19, View B proponents believe that convertible debt instruments that require or permit partial cash settlement upon conversion are not within the scope of APB 14. However, View B proponents believe that the economic substance of those instruments embodies two components, a debt instrument with a below-market interest rate and a net-share-settled equity instrument. Accordingly, those proponents believe that the accounting model described in Exhibit 07-2A of this Issue Summary should be applied to appropriately reflect the economic substance of instruments within the scope of this Issue. Proponents of View B believe that the resulting interest yield under that approach provides the best representation of the issuer's economic borrowing costs by giving accounting recognition to the portion of those borrowing costs that were "paid" to the investors through the equity component.
21. Opponents of View B observe that the holder of a convertible debt instrument within the scope of this Issue is not entitled to separately transfer the debt and the conversion option, so the two components should be considered "inseparable." Those opponents also observe that the debt and the conversion option are settled concurrently, regardless of whether the convertible debt instrument is ultimately settled for its principal amount or its if-converted value. Accordingly, View B opponents believe that APB 14 applies to convertible debt instruments that require or permit partial cash settlement upon conversion, based on the discussion of inseparability in paragraphs 7 and 12 of that Opinion.

22. View B proponents believe that the financial reporting benefits of separately accounting for the liability and equity components of a convertible debt instrument that requires or permits partial cash settlement upon conversion outweigh the costs or practical difficulties associated with the application of that treatment. Those proponents observe that such treatment is already required under IFRS for convertible debt instruments that contain both a liability component and an equity component. Additionally, View B proponents observe that convertible debt instruments issued in the U.S. often contain contingent interest provisions that enable the issuer to receive a tax deduction based on the nonconvertible debt rate.\(^4\) In some cases, entities purchase call options on their own stock concurrently with the issuance of convertible debt and the two instruments are integrated for tax purposes, resulting in a tax deduction that is similar to the entity's nonconvertible debt rate. In other words, many issuers of convertible debt instruments, including convertible debt instruments that require or permit partial cash settlement upon conversion, are already performing computations similar to those that would be required under View B in connection with the preparation of their U.S. federal income tax returns. The accounting treatment under View B would also eliminate the need to evaluate whether a convertible instrument that requires or permits partial cash settlement upon conversion contains a beneficial conversion feature.

**Interaction with FAS 133 and APB 14**

23. This Issue does not impact the issuer's accounting for convertible debt instruments when the conversion option is separately accounted for as a derivative, so it does not affect the guidance in

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\(^4\) Refer to IRS Revenue Ruling 2002-31.
FAS 133. Additionally, a consensus on this Issue would not amend the guidance in APB 14; therefore, none of the alternative views would affect the accounting for convertible debt instruments that are determined to be within the scope of APB 14. Rather, this Issue addresses whether convertible debt instruments that require or permit partial cash settlement upon conversion are within the scope of APB 14 and would provide guidance on the appropriate accounting for such instruments if the Task Force reaches a consensus that APB 14 does not apply.

**International Convergence**

24. Neither of the alternative views in this Issue Summary would converge with IFRS for instruments within the scope of this Issue because the requirements for equity classification in U.S. GAAP (Issue 00-19) differ from the requirements for equity classification under IFRS (IAS 32). For instruments within the scope of this Issue, the issuer has the ability to net-share settle the conversion spread upon conversion. As a result, the conversion option embedded in a convertible debt instrument within the scope of this Issue would not meet the conditions for equity classification under IAS 32; rather, it would be accounted for separately as a derivative instrument pursuant to the guidance in IAS 39, unless the issuer elects to measure the entire instrument at fair value. If a conversion option embedded in a convertible debt instrument that requires or permits partial cash settlement upon conversion does not meet the requirements for equity classification under Issue 00-19, it would be separately accounted for as a derivative for U.S. GAAP purposes as well and would not be within the scope of this Issue.

**Interaction with Other Board Agenda Projects**

25. In December 1996, the Board decided to resume deliberations on issues raised in the Discussion Memorandum on liability and equity instruments, which was issued in 1990. The objective of the liabilities and equity project is to develop a comprehensive standard of accounting and reporting for financial instruments with characteristics of equity, liabilities, or both, and assets. Such a standard would likely replace the accounting requirements in APB 14 for all convertible debt instruments, including convertible debt instruments within the scope of this Issue.
26. The liabilities and equity project is being conducted under a modified joint approach with the IASB. Under that approach, the FASB's initial due process document will be in the form of a Preliminary Views, which is expected to be issued in June 2007. That document will be concurrently published by the IASB for comment by its constituents. The Boards plan to use the input received on those initial due process documents as the basis for a joint project to develop a common standard of accounting and reporting. In that joint project, the Boards will deliberate and develop a proposed Statement, to be followed by joint redeliberations and development of a common final Statement. A final statement resulting from the liabilities and equity project is not expected for several years (no specific target date has been set for its issuance).

Transition and Effective Date

27. If the Task Force reaches a consensus on View A, no transition guidance is required because the existing guidance in Issue 90-19 would continue to apply. If the Task Force reaches a consensus on View B, the FASB staff recommends that the consensus be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Early adoption would be permitted.

28. The staff believes that the Task Force should consider transition alternatives if a consensus is reached on View B. The staff has identified three transition alternatives that are described below. The following discussion of these transition alternatives requires an understanding of the accounting treatment under View B (refer to Exhibit 07-2A).

Alternative A – Retrospective Application under FAS 154

Retrospective application under FAS 154 requires the following:

a. The cumulative effect of the change to the new accounting principle on periods prior to those presented shall be reflected in the carrying amounts in the statement of financial position as of the beginning of the first period presented.

b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.
c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle.

In circumstances in which it is impracticable to apply a View B consensus to all periods presented (for example, the issuer is unable to obtain information about market interest rates and its own credit standing as of the instrument's issuance date), an entity shall allocate the carrying amount of a convertible instrument between its liability component and equity component as of the earliest date that the fair value of the liability component can be determined (using the fair value of the liability component at that date). In those circumstances in which retrospective application to all prior periods is impracticable, an issuer shall disclose (1) the reasons therefore, (2) the earliest date that the fair value of the liability component could be determined (the separation date), and (3) the reported interest cost for the convertible instrument for the portion of the fiscal year prior to the separation date and for the portion of the fiscal year after the separation date.

Supporters of retrospective application cite the following factors as support for this transition methodology:

- Supporters of retrospective application believe that convertible debt instruments that require or permit partial cash settlement upon conversion were not common before the consensus on Issue 90-19 was revised in January 2002. Additionally, the proportion of convertible debt instruments that require or permit partial cash settlement upon conversion increased in late 2004, when the Task Force reached a consensus on Issue 04-8 that eliminated the diluted earnings-per-share benefits of Co-Cos that contain a market price trigger. Due to the availability of information regarding market interest rates for such recent periods, it is expected that entities would have access to the inputs that would be required to measure the fair value of the liability component of instruments within the scope of this Issue.

- Convertible debt instruments within the scope of this Issue frequently incorporate features that enable the issuer to obtain a tax deduction based on the issuer's nonconvertible debt rate (for example, purchased call options on the issuer's own stock that achieve tax integration with the convertible debt and contingent interest provisions).
Many of those issuers have already been performing computations similar to those that would be required under View B in connection with the preparation of their U.S. federal income tax returns, so there would not be undue cost and effort involved with retrospective application.

- The FASB’s conceptual framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. Paragraph B7 of FAS 154 specifies that "the Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data."

- Convertible debt instruments within the scope of this Issue that were issued by various entities in prior periods may appear comparable under the guidance in Issue 90-19, as revised, if those instruments were issued at par with the same coupon rate of interest. However, the economic borrowing costs incurred by those issuers may differ significantly because of differences in credit standing and differences in market interest rates between the respective issuance dates that required some issuers to provide more valuable conversion options than others. Accordingly, proponents of retrospective application believe that the lack of diversity from an accounting perspective does not necessarily mean that the historical financial statements of issuers of convertible debt instruments within the scope of this Issue provide comparable information from an economic perspective.

**Alternative B – Cumulative-Effect Adjustment to Beginning Retained Earnings**

Under a cumulative-effect adjustment transition methodology, an entity would determine the respective carrying amounts of the liability and equity components of the convertible debt instrument that would have been recognized at the date of adoption under retrospective application. The difference between (1) the sum of those carrying amounts upon adoption and (2) the carrying amount of the convertible instrument immediately prior to adoption would be recognized as a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial
position) for that fiscal year, presented separately.\textsuperscript{5} For all periods presented, disclosure of the pro forma effects of retrospective application, including earnings-per-share amounts, would be required.

Proponents of transition through a cumulative-effect adjustment to beginning retained earnings observe that there are costs associated with revising prior year information in financial statements and SEC filings, including personnel and audit-related costs. Those proponents observe that a cumulative-effect transition methodology will result in the same interest cost in subsequent periods that would be recognized under retrospective transition. Additionally, the proposed requirement to disclose the pro forma effects of retrospective application would provide investors with information to use for comparative purposes.

29. The staff believes that a View B consensus should \textbf{not} be applied to convertible debt instruments that are no longer outstanding (or no longer require or permit partial cash settlement upon conversion) at the date of adoption, regardless of which transition alternative is applied. However, for entities that modify the terms of a convertible instrument prior to the date of adoption in a manner that will require application of the if-converted method of computing diluted earnings per share in subsequent periods (for example, modifying the terms of a convertible instrument within the scope of this Issue such that it would be considered "conventional" under Issue 05-2), disclosure of pro forma earnings-per-share information illustrating the application of the if-converted method in prior periods would be required for comparative purposes.

30. If the Task Force reaches a consensus on View B, the staff does not believe that there is a basis for grandfathering existing instruments within the scope of this Issue. That is, if the Task Force concludes that APB 14 does not apply to convertible debt instruments that require or permit partial cash settlement upon conversion, it would not appear to be appropriate for issuers to continue applying that guidance to those instruments. Additionally, it does not appear that comparable financial reporting would result if entities that issued convertible debt instruments

\textsuperscript{5} Typically, the cumulative effect adjustment under this methodology would represent the interest expense that would have been recognized in prior periods had a consensus on View B been applied since the original issuance of the instrument, net of any related tax effects.
within the scope of this Issue before its effective date were permitted to continue to apply APB 14, while issuers of the same convertible debt instruments after the effective date of this Issue would be required to recognize the economic interest cost of such instruments attributable to both the cash interest payments and the embedded conversion option.
A1. This exhibit describes the accounting model that would apply to instruments within the scope of this Issue under View B, including a discussion of the principles underlying such treatment.

**Accounting Treatment under View B**

*Initial Measurement*

A2. The issuer of a convertible debt instrument that requires or permits partial cash settlement upon conversion would first determine the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded derivative features other than the conversion option) that does not have an associated equity component. The carrying amount of the equity instrument represented by the embedded conversion option is then determined by deducting the fair value of the liability component from the initial proceeds ascribed to the convertible instrument as a whole.

A3. If the liability component contains embedded derivatives other than the embedded conversion option (for example, embedded prepayment options), the guidance in FAS 133 shall be applied to determine if any of those features must be separately accounted for as derivative instruments.

*Subsequent Measurement*

A4. The liability component is subsequently accounted for pursuant to the guidance in APB 21. Under that guidance, the excess of the principal amount of the liability over its initial fair value should be accreted to interest expense using the interest method.

A5. The equity component (conversion option) is not remeasured as long as it continues to meet the conditions for equity classification in Issue 00-19. If the conversion option is required to be reclassified from equity to a liability measured at fair value each period under Issue 00-19, the
difference between the amount previously recognized in equity and the fair value of the conversion option at the date of reclassification should be accounted for as an adjustment to equity. If a conversion option that was previously reclassified out of equity is subsequently reclassified back to equity, Issue 00-19 specifies that gains or losses recorded to account for the conversion option at fair value during the period it was classified as a liability should not be reversed. Reclassifications of the conversion option would not affect the accounting for the liability component.

Modifications and Settlements

A6. An issuer would apply the guidance in Issues 06-6 and 96-19 to determine whether a modification to an instrument within the scope of this Issue should be accounted for as an extinguishment (see discussion of settlement accounting below) or as a modification. If a modification does not result in extinguishment accounting under Issues 06-6 and 96-19, then a new effective interest rate for the liability component is determined pursuant to the guidance in those Issues. If an instrument within the scope of this Issue is modified such that the conversion option no longer requires or permits partial cash settlement upon conversion (for example, the convertible instrument is modified such that it meets the characteristics of a "conventional convertible debt instrument" as set forth in Issue 05-2), the components of the instrument shall continue to be accounted for separately unless extinguishment accounting is required under Issues 06-6 and 96-19.

A7. If an instrument within the scope of this Issue is settled through the issuance of cash, stock, or any combination thereof, or if a significant modification or exchange of an instrument within the scope of this Issue is accounted for as an extinguishment, the settlement transaction would be accounted for as follows:

1. Measure the fair value of the consideration transferred to the holder. If the transaction is a significant modification or exchange that is accounted for as an extinguishment under Issues 06-6 and 96-19, the new debt instrument (including both the liability and equity components if the new instrument is also within the scope of this Issue) is the consideration transferred to the holder that is measured at fair value.
2. Allocate the fair value of the consideration transferred to the holder between the liability and equity components of the old debt instrument as follows:
   a. Allocate a portion of the settlement consideration to the extinguishment of the liability component equal to the fair value of that component immediately prior to extinguishment. Any difference between the consideration allocated to the liability component and its carrying amount is recognized in the income statement as a gain or loss on debt extinguishment.
   b. Allocate the remaining settlement consideration to the reacquisition of the equity component. Any difference between the consideration allocated to the equity component and its carrying amount is recognized in equity.

A8. If an entity amends the terms of a convertible instrument to induce early conversion, FAS 84 requires the debtor to recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. That is, the guidance in FAS 84 would apply to induced conversions of instruments within the scope of this Issue in the same manner in which it applies to convertible debt instruments that are not within the scope of this Issue. The settlement accounting treatment described in the previous paragraph would then be applied using the fair value of the securities that were issuable pursuant to the original conversion terms.

**Basis for Accounting Treatment under View B**

*Initial Measurement*

A9. The basic principle underlying the proposed accounting treatment under View B is that the issuer of a convertible debt instrument that requires or permits partial cash settlement upon conversion be required to recognize the same interest cost as it would have incurred had it issued a debt instrument with the same terms but without the embedded conversion option. That is, the equity component is measured as a residual amount representing the interest cost that was "paid" with the conversion option. Accordingly, separation is achieved by measuring the fair value of a similar liability that does not have an associated equity component. This separation methodology is consistent with IAS 32 for convertible debt instruments that contain liability and
equity components under that standard and it is less complex to apply than other alternative approaches to separation, such as the approaches described in the following paragraphs. Paragraph BC30 of IAS 32 indicates that this separation methodology "removes the need to estimate inputs to, and apply, complex option pricing models to measure the equity component of some compound financial instruments."

A10. Other guidance in U.S. GAAP contains allocation requirements that are intended to accomplish other objectives. For example, FAS 133 requires that derivative instruments within the scope of that Statement be measured initially and subsequently at fair value. Consequently, an embedded derivative (including an embedded conversion option) that requires separation under FAS 133 is initially measured at fair value, with the residual proceeds allocated to the host contract. That separation methodology is intended to measure the embedded derivative at its fair value, not to generate a particular interest cost on the debt host.

A11. APB 14 requires that the proceeds from an offering of nonconvertible debt and equity-classified warrants be allocated on a relative fair value basis between the debt and the warrants. That guidance is intended to provide an allocation mechanism between two freestanding financial instruments, not to generate a particular interest cost on the debt instrument. Additionally, a relative fair value separation methodology is more complex to apply than the separation methodology under View B because it requires two fair value measurements—the liability component and the equity component. A relative fair value separation methodology was considered and rejected by the IASB in IAS 32.

Subsequent Measurement

A12. The subsequent measurement guidance under View B would require the application of other U.S. GAAP (APB 21 and Issue 00-19, respectively) to the liability and equity components. This Issue does not prescribe the term over which a debt discount is required to be accreted for debt instruments with embedded call and put options because such an interpretation of APB 21 is beyond the scope of this Issue.

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6 As described in paragraph 24 of this Issue Summary, the requirements for equity classification in U.S. GAAP (Issue 00-19) differ from the requirements for equity classification under IFRS (IAS 32).
Modifications and Settlements

A13. For purposes of determining whether a modification or an exchange of convertible debt instruments within the scope of this Issue should be accounted for as an extinguishment, View B would require the application of other U.S. GAAP. Such guidance is provided in Issues 06-6 and 96-19 and is applicable to instruments within the scope of this Issue. If an instrument within the scope of this Issue is modified such that the conversion option no longer requires or permits partial cash settlement upon conversion (for example, the convertible instrument is modified such that it meets the characteristics of a "conventional convertible debt instrument" as set forth in Issue 05-2), View B would require that the components of the instrument shall continue to be accounted for separately unless extinguishment accounting is required under Issues 06-6 and 96-19. This guidance is based on the Task Force's recent decision in Issue 06-7 that APB 14 only applies at inception; therefore, a convertible debt instrument within the scope of this Issue that is originally separated into liability and equity components should not be recombined at a later date. Rather, the liability component should continue to be accreted such that the issuer's economic interest cost continues to be reflected in the financial statements.

A14. The principle underlying the View B guidance on modifications and settlements is that, upon any settlement of a convertible debt instrument within the scope of this Issue, an entity is extinguishing the liability component and reacquiring the equity component. Accordingly, the fair value of the consideration transferred to the holder at settlement (regardless of the form of that consideration) is allocated between the liability and equity components using the same methodology that was applied when the original proceeds received by the issuer were allocated between those components. This allocation methodology at settlement is consistent with IAS 32 for convertible debt instruments that contain both liability and equity components under that standard. Additionally, the requirement to continue to apply the guidance in FAS 84 to account for induced conversions of instruments within the scope of this Issue is consistent with IAS 32 (paragraph AG35), which contains the same accounting guidance as FAS 84.
APPLICATION OF THE ALTERNATIVE VIEWS

B1. The following example illustrates the application of the alternative views set forth in this Issue Summary. For purposes of this example, assume the embedded conversion option does not require separate accounting as a derivative instrument under FAS 133 because it qualifies for the scope exception in paragraph 11(a) of that Statement. Additionally, income tax effects are not presented in these illustrative journal entries because the income tax benefits for an issuer of convertible debt instruments can differ depending on the specific terms of the instruments.

On January 1, 2007, Company A issues 100,000 convertible notes at their par value of $1,000 per note, raising total proceeds of $100,000,000. The notes bear interest at a fixed rate of 2 percent per annum, payable annually in arrears on December 31, and are scheduled to mature on December 31, 2016. Each $1,000 par value note is convertible at any time into the equivalent of 10 shares of Company A's common stock (that is, representing a stated conversion price of $100 per share). The quoted market price of Company A's common stock is $70 per share on the date of issuance. Upon conversion, Company A can elect to settle the entire if-converted value (that is, the principal amount of the debt plus the conversion spread) in cash, common stock, or any combination thereof. At issuance, the prevailing market interest rate for similar debt without a conversion option is 8 percent. The par value of Company A's common stock is $0.01 per share.

On January 1, 2012, when the quoted market price of Company A's common stock is $140 per share, all holders of the convertible notes exercise their conversion options. Accordingly, those investors are entitled to aggregate consideration of $140,000,000 ($1,400 per note). At settlement, the prevailing market interest rate for similar debt without a conversion option is 7 percent.
Initial Measurement

View A

B2. At issuance, Company A would record the following under View A:

Dr. Cash 100,000,000  
Cr. Debt 100,000,000

View B

B3. Under View B, the liability component is measured first, and the difference between the proceeds of the notes issuance and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 8 percent, the market rate for similar notes that have no conversion rights, as shown below.

<table>
<thead>
<tr>
<th>Description</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of the principal</td>
<td>$46,319,349</td>
</tr>
<tr>
<td>Present value of interest</td>
<td>$13,420,163</td>
</tr>
<tr>
<td>Total liability component</td>
<td>$59,739,512</td>
</tr>
<tr>
<td>Total equity component (100,000,000 − 59,739,512)</td>
<td>$40,260,488</td>
</tr>
</tbody>
</table>

B4. At issuance, Company A would record the following under View B:

Dr. Cash 100,000,000  
Dr. Debt discount 40,260,000  
Cr. Debt 100,000,000  
Cr. Additional paid-in capital 40,260,000

Subsequent Measurement

View A

B5. Company A would record the following under View A to recognize interest expense based on the 2 percent cash interest coupon:
2007 – 2011
Dr. Interest expense 2,000,000
Cr. Cash 2,000,000

View B
B6. Company A would record the following under View B to recognize interest expense using the effective interest method based on the 8 percent market rate for similar notes that have no conversion rights:

2007
Dr. Interest expense 4,779,000
Cr. Cash 2,000,000
Cr. Debt discount 2,779,000

2008
Dr. Interest expense 5,001,000
Cr. Cash 2,000,000
Cr. Debt discount 3,001,000

2009
Dr. Interest expense 5,242,000
Cr. Cash 2,000,000
Cr. Debt discount 3,242,000

2010
Dr. Interest expense 5,501,000
Cr. Cash 2,000,000
Cr. Debt discount 3,501,000
2011

Dr. Interest expense 5,781,000
Cr. Cash 2,000,000
Cr. Debt discount 3,781,000

Settlement

View A

B7. At settlement, Company A would record the following under View A (pursuant to the guidance in Issue 03-7) if it elects to transfer consideration to the holder in the form of $100,000,000 cash and 285,714 shares of common stock (with a fair value of $40,000,000):

Dr. Debt 100,000,000
Dr. Additional paid-in capital 3,000
Cr. Cash 100,000,000
Cr. Common stock at par 3,000

B8. At settlement, Company A would record the following under View A (pursuant to the guidance in Issue 03-7) if it elects to transfer consideration to the holder in the form of $140,000,000 cash:

Dr. Debt 100,000,000
Dr. Loss on debt extinguishment 40,000,000
Cr. Cash 140,000,000

View B

B9. Under View B, the fair value of the liability component immediately prior to extinguishment is measured first, and the difference between the fair value of the aggregate consideration remitted to the holder ($140,000,000) and the fair value of the liability component is allocated to the reacquisition of the equity component. The present value of the liability component (which
has a remaining term of 5 years at the settlement date) is calculated using a discount rate of 7 percent, the market rate for similar notes that have no conversion rights, as shown below.

Present value of the principal - $100,000,000 payable in 5 years $ 71,298,618
Present value of interest - $2,000,000 payable annually in arrears for 5 years 8,200,395
Consideration allocated to liability component $ 79,499,013
Consideration allocated to equity component ($140,000,000 – $79,499,013)  $ 60,500,987

B10. Regardless of the form of the $140,000,000 consideration transferred at settlement, $79,499,000 would be allocated to the extinguishment of the liability component and $60,501,000 would be allocated to the reacquisition of the equity component. The carrying amount of the liability is $76,044,000 ($100,000,000 principal – $23,956,000 unamortized discount) at the December 31, 2011 settlement date, resulting in a $3,455,000 loss on extinguishment.

B11. At settlement, Company A would record the following under View B if it elects to transfer consideration to the holder in the form of $100,000,000 cash and 285,714 shares of common stock (with a fair value of $40,000,000). The $60,501,000 decrease to additional paid-in capital for the reacquisition of the conversion option and the $39,997,000 increase to additional paid-in capital from the issuance of common stock at conversion are presented on a gross basis in this journal entry for illustrative purposes.

Dr. Debt 100,000,000
Dr. Additional paid-in capital 60,501,000
Dr. Loss on extinguishment 3,455,000
Cr. Debt discount 23,956,000
Cr. Cash 100,000,000
Cr. Common stock at par 3,000
Cr. Additional paid-in capital 39,997,000
B12. At settlement, Company A would record the following under View B if it elects to transfer consideration to the holder in the form of $140,000,000 cash:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Debt 100,000,000</td>
<td>Cr. Debt discount 23,956,000</td>
</tr>
<tr>
<td>Dr. Additional paid-in capital 60,501,000</td>
<td>Cr. Cash 140,000,000</td>
</tr>
<tr>
<td>Dr. Loss on extinguishment 3,455,000</td>
<td></td>
</tr>
</tbody>
</table>
IMPACT OF A VIEW B CONSENSUS ON OTHER EITF ISSUES

C1. A consensus on View B of this Issue would impact other EITF Issues as follows:

Issue 90-19
C2. A consensus on View B of this Issue would affect the accounting guidance in Issue 90-19 as follows:

The Task Force reached a consensus on Issues 1 and 2 that Instrument C should be accounted for pursuant to the guidance in Issue No. 07-2, "Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement upon Conversion," like convertible debt (that is, as a combined instrument) if the conversion spread meets the requirements of Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," including the provisions contained in paragraphs 12–32 of Issue 00-19. If the conversion spread feature does not meet those provisions, it is within the scope of Statement 133 and should be accounted for in accordance with the provisions of that Statement (that is, bifurcated and accounted for as a derivative instrument).

C3. A consensus on View B of this Issue would not affect the earnings-per-share guidance in Issue 90-19 for Instrument C. Additionally, a consensus on View B of this Issue would not affect the guidance in Issue 90-19 on the accounting and earnings-per-share treatment of the convertible instruments characterized as Instrument A and Instrument B in that Issue.

Issue 98-5
C4. A consensus on View B of this Issue would affect the scope of Issue 98-5 as follows:

3. This Issue applies to convertible securities with beneficial conversion features that must be settled in stock and to those that give the issuer a choice of settling the entire obligation in either cash or stock or cash equivalent to the conversion value. This Issue also applies to
instruments with beneficial conversion features that are convertible into multiple instruments, for example, a convertible preferred stock that is convertible into common stock and detachable warrants. In addition, this Issue applies to instruments with conversion features that are not beneficial at the commitment date but that become beneficial upon the occurrence of a future event, such as an initial public offering. This Issue does not apply to instruments within the scope of Issue No. 07-2, "Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement upon Conversion."

Issue 00-27
C5. A consensus on View B of this Issue would affect the scope of Issue 00-27 as follows:

1. Issue No. 98-5, "Accounting forConvertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," address the accounting for convertible debt instruments and convertible preferred stock (collectively, convertible instruments) with nondetachable conversion options that are in-the-money (see Part II, Issue 1 for additional guidance on determining when a conversion option is in-the-money) at the commitment date. Issue 98-5 also addresses an issuer's accounting for convertible instruments that have conversion prices that are variable based on future events. Issue 98-5 does not apply to instruments within the scope of Issue No. 07-2, "Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement upon Conversion." The Task Force reached a consensus on Issue 98-5 at the May 19–20, 1999 meeting. Subsequent to the consensus, a number of issues about the application of the Issue 98-5 model have been raised.

Issue 03-7
C6. A consensus on View B of this Issue would nullify the consensus in Issue 03-7.

Issue 05-1
C7. A consensus on View B of this Issue would affect the accounting guidance in Issue 05-1 as follows:
4. This Issue applies to the issuance of equity securities to settle a debt instrument that was not otherwise currently convertible but became convertible upon the issuer's exercise of a call option when the issuance of equity securities is pursuant to the instrument's original conversion terms. Statement 84 provides guidance about conversions pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance to induce conversion and Issue [06-6] provides guidance about modifications to embedded conversion options. The guidance in this Issue does not apply to debt instruments that are within the scope of Issue No. 07-2, "Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement upon Conversion."

10. When extinguishment accounting is required under this Issue upon the settlement of a debt instrument with the characteristics of Instrument C in Issue 90-19, the reacquisition price for the debt would include the cash payment for the accreted value of the debt and fair value of the equity instruments issued to settle the conversion spread. Pursuant to the guidance in Issue 03-7, for the settlement of a debt instrument with the characteristics of Instrument C as described in Issue 90-19 that is accounted for as a conversion under this Issue, the reacquisition price of the debt would not consider any shares transferred to settle the embedded equity instrument (the excess conversion spread in Issue 90-19).