

FASB Emerging Issues Task Force

Issue No. 00-27

Title: Application of Issue No. 98-5 to Certain Convertible Instruments

Document: Issue Summary No. 1, Supplement No. 1*

Date prepared: February 28, 2008

FASB Staff: Zecher (ext. 279) / Stevens (ext. 226)

Date previously discussed: November 15–16, 2000; January 17–18, 2001

Previously distributed EITF materials: Issue Summary No. 1, Working Group Report No. 1;
Working Group Report No. 2

References:

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

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

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

* The alternative views presented in this Issue Summary Supplement 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.

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. The Task Force reached a consensus on Issue 98-5 in May 1999. Subsequent to that consensus, a number of issues about the application of the Issue 98-5 intrinsic value model arose.

2. In response, Issue 00-27 was added to the EITF agenda to address certain practice issues resulting from application of the Issue 98-5 model and, in the event that those issues could not be adequately addressed within the existing framework, to consider the need for a different model. Additionally, a Working Group was formed to assist the FASB staff in addressing those 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 model (Part I of Issue 00-27). At that meeting, the Task Force also reached 10 additional consensuses and 3 tentative conclusions (Issues 12(a), 12(b), and 12(c)) on application issues relating to the Issue 98-5 model (Part II of Issue 00-27).¹

3. Subsequent to the November 2000 meeting, the Working Group met and recommended that any conclusions reached by the Task Force on the remaining issues should be considered tentative until the Working Group and the FASB staff have codified the Issue 98-5 model and the guidance in Issue 00-27. At the January 17–18, 2001 EITF meeting, as recommended by the Working Group, the Task Force reached tentative conclusions on most of the remaining issues and requested that the FASB staff codify the consensuses and tentative conclusions in Issues 98-5 and 00-27 into a single abstract.²

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.

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.

4. On March 19, 2001, the Working Group held its third meeting to discuss a draft of the codified abstract prepared by the FASB staff. However, during that meeting, the Working Group and FASB staff determined that (a) further discussion of the application issues in Issue 00-27 for which the Task Force had not reached a final consensus and (b) codification of Issues 98-5 and 00-27 into a single abstract should both cease pending developments on the FASB's liabilities and equity project. No further discussions were held by the Working Group or the Task Force.

5. As a result of the decision not to proceed further, Issue 00-27 currently includes 10 final consensus on application issues and tentative conclusions on 9 additional application issues (including sub-issues). Therefore, the open issues in Issue 00-27 (that is, those with either a tentative conclusion or no conclusion) are the following:

Issue 12 If a convertible instrument that included a beneficial conversion option under Issue 98-5 is extinguished prior to its stated maturity date, how Issue 98-5 should be applied to the reacquisition of the embedded conversion option.

Issue 12(a) Whether it is appropriate to allocate a portion of the reacquisition price to the conversion option based on the intrinsic value of that option at the extinguishment date if no separate accounting for the conversion option under Issue 98-5 has occurred.

Issue 12(b) How the requirement to allocate a portion of the reacquisition price to the beneficial conversion option for convertible debt should be applied if the intrinsic value of that option at the date of extinguishment is greater than the originally measured intrinsic value.

Issue 12(c) Whether it is ever appropriate to allocate a portion of the reacquisition price to an embedded beneficial conversion option on the issuer's common stock upon the early redemption of convertible preferred stock.

Issue 13 A company issues a warrant that allows the holder to acquire a convertible instrument for a stated exercise price. The warrant provides only for physical settlement (that is, delivery of the convertible instrument in exchange for the stated exercise price) and is classified as an equity instrument (either temporary or permanent). The issue is how to measure and when to recognize a beneficial conversion option in the underlying warrant.

Issue 13(a) Whether the commitment date for purposes of measuring the intrinsic value of the conversion option in the convertible instrument that is the underlying for the warrant is (a) the commitment date for the warrant or (b) the exercise date of the warrant.

Issue 13(b) When measuring the intrinsic value of a conversion option embedded in a convertible instrument that is the underlying for the warrant, how the deemed proceeds for the convertible instrument should be computed.

Issue 13(c) Whether the measured intrinsic value of a beneficial conversion option in a convertible instrument that is the underlying for the warrant should be recognized at the date the warrant is issued or at the date the warrant is exercised and the convertible instrument is issued.

Issue 14 A company issues a warrant that allows the holder to acquire a convertible instrument for a stated exercise price. The warrant provides only for physical settlement (that is, delivery of the convertible instrument in exchange for the stated exercise price) and is classified as a liability instrument. The issues are (1) whether the commitment date for purposes of measuring the intrinsic value of a conversion option in a convertible instrument that is the underlying for a warrant is (a) the commitment date for the warrant or (b) the exercise date of the warrant, (2) how the deemed proceeds for the convertible instrument should be computed, and (3) when the intrinsic value of a beneficial conversion option in the underlying convertible instrument should be recognized.

Issue 15 How a beneficial conversion amount should be measured when an entity issues a convertible instrument that, if converted, will result in the holder receiving common stock and other equity instruments of the issuer, such as warrants to acquire common stock of the issuer.

Issue 16(a) Whether there should be specific presentation or disclosure requirements for convertible instruments subject to Issue 98-5 (as interpreted by Issue 00-27).

Issue 16(b) Whether a convertible preferred stock that has a conversion option within the scope of the Issue 98-5 model (as interpreted by Issue 00-27) should be classified as either permanent or temporary equity using the guidance in Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

Recent Developments

6. During the discussion of administrative matters at the November 29, 2007 EITF meeting concerning proposed clarifications to Issue 98-5, some Task Force members observed that there is a dormant item on the EITF agenda regarding Issue 00-27 and suggested that the Task Force consider deliberating the remaining open issues. Other Task Force members asserted that the complexity associated with the guidance in Issues 98-5 and 00-27 would be reduced if those two Issues were codified under a single abstract.

7. Accordingly, the FASB staff requested that the EITF Agenda Committee provide input on the following two issues at its January 10, 2008 meeting.

- Whether the Task Force should consider the dormant issues from Issue 00-27
- Whether Issues 98-5 and 00-27 should be codified into a single abstract.

8. The Agenda Committee recommended that the EITF remove Issue 00-27, along with all of its open issues, from the EITF agenda. In forming its recommendation, the Agenda Committee considered the following:

Factors against Addressing the Open Issues

- Upon issuance of the Board's final standard on financial instruments with characteristics of equity, it is expected that there will be one comprehensive standard that addresses accounting for financial instruments with characteristics of equity. As such, upon issuance of that standard, both Issues 98-5 and 00-27 will be nullified in their entirety.
- It will likely take extensive time to redeliberate Issues 98-5 and 00-27, and any decisions reached by the Task Force may shortly thereafter be nullified by the issuance of the Board's final standard on financial instruments with characteristics of equity.
- The FASB has received very few technical inquiries relating to the tentative conclusions in Issue 00-27. It is the FASB staff's understanding that there is little diversity in practice concerning those tentative conclusions. Although the conclusions are tentative, as there is no other authoritative literature to address these issues, reporting entities have looked to the

tentative conclusions for guidance. Furthermore, it is the staff's understanding that there are currently relatively few transactions to which the issues would apply.

Factors in Favor of Addressing the Open Issues

- The 9 tentative conclusions have been treated as authoritative GAAP by practitioners when evaluating the accounting for the corresponding transactions. Therefore, formal guidance should be provided, noting that such guidance would otherwise be eliminated when the FASB Codification project is completed.

Does the Task Force affirm the removal of Issue 00-27 from the agenda of open issues?

9. The Agenda Committee recommended that Issues 98-5 and 00-27 not be codified into a single abstract. In making its decision, the Agenda Committee considered the following:

Factors against Codifying Issues 98-5 and 00-27

- There is currently an ongoing FASB project that will codify all authoritative accounting literature. The first portion of the FASB Codification was released in January 2008 for verification by constituents. The FASB Codification will not only codify Issues 98-5 and 00-27, but all of the accounting literature relating to convertible instruments. Additionally, the FASB staff will continue to work with the codification team to ensure that the beneficial conversion feature literature is properly reflected in the FASB Codification.
- Given the various other pieces of accounting literature that will need to be considered in evaluating the accounting for convertible instruments, there will be no substantive reduction in complexity as a result of combining Issues 98-5 and 00-27 into a single abstract.

Factors in Favor of Codifying Issues 98-5 and 00-27

- Codification of Issues 98-5 and 00-27 into a single abstract may reduce complexity for preparers and auditors because the guidance on accounting for beneficial conversion features would be contained in one place.

Does the Task Force agree that Issues 98-5 and 00-27 should not be codified into a single abstract outside of the FASB Codification project?