FASB Emerging Issues Task Force

Issue No: 07-2

Title: Accounting for Convertible Debt Instruments That Are Not Subject to the Guidance in Paragraph 12 of APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*

Document: Working Group Report No. 1*

Date Prepared: May 31, 2007

FASB Staff: Stevens (ext. 226) / Sarno (ext. 441)

EITF Liaison: James Johnson

Date Previously Discussed: March 15, 2007

Previously Distributed EITF Materials: Issue Summary No. 1, dated February 28, 2007

References:

FASB Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123(R))

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. 155, *Accounting for Certain Hybrid Financial Instruments* (FAS 155)

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159)

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

International Accounting Standard 32, *Financial Instruments: Disclosure and Presentation* (IAS 32)

* **The alternative views presented in this Working Group Report 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.**

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. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128" (Issue 03-6)

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

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 and Prior EITF Discussion

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 scope of APB 14 and its applicability to certain structured convertible debt instruments was not addressed in connection with those deliberations.

2. Paragraph 12 of APB 14 provides the following guidance on accounting for the convertible debt instruments that are discussed therein:

> 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 practical difficulties.

3. Paragraph 3 of APB 14 describes general characteristics of convertible debt instruments that are subject to the guidance in paragraph 12 of 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.

4. Paragraph 18 of APB 14 specifies that the guidance in that Opinion is not intended to apply to all types of convertible debt instruments and contains the following discussion regarding the accounting for instruments not addressed therein:

> 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.

5. Notwithstanding the discussion in paragraph 18 of APB 14, practice has evolved since the issuance of APB 14 to interpret the guidance in paragraph 12 of APB 14 to apply broadly, at issuance, to all convertible debt instruments except in the following circumstances:

a. The conversion option is required to be separately accounted for at fair value as a derivative pursuant to the guidance in FAS 133. For example, a convertible debt instrument that permits the holder to elect cash settlement upon conversion.
b. The convertible debt instrument contains a beneficial conversion feature that must be separately accounted for in equity pursuant to the guidance in Issues 98-5 and 00-27. That is, the embedded conversion feature is in-the-money at the commitment date.[1]
c. The convertible debt instrument is issued at a substantial premium and some portion of the proceeds is allocated to paid-in capital pursuant to the guidance in paragraph 18 of APB 14. For example, a convertible debt instrument is modified or exchanged in a manner that requires the application of extinguishment accounting under Issues 96-19 and 06-6 and the fair value of the modified instrument significantly exceeds its par value.
d. The convertible debt instrument in its entirety is reported at fair value with changes in fair value recognized in earnings pursuant to the issuer's election of the fair value option under FAS 155 or FAS 159.[2]
e. The conversion option embedded in a debt instrument can be legally detached and separately exercised. For example, a convertible debt instrument permits net-share settlement of the conversion option such that the debt obligation remains outstanding and resets to a market rate for nonconvertible debt.

[1] Issues 98-5 and 00-27 also provide guidance on accounting for contingent beneficial conversion features that may arise due to adjustments to the conversion rate subsequent to issuance.
[2] Convertible debt instruments that are partially classified in equity (for example, convertible debt with a beneficial conversion feature) are not eligible for the fair value option under FAS 159.

6. Although APB 14 specifies that instruments not explicitly discussed in that Opinion should be accounted for based on their substance, it appears that such guidance is not typically invoked in practice unless there is specific authoritative literature requiring an alternative accounting treatment. For example, the staff understands that convertible debt instruments frequently contain provisions that provide for adjustments to the conversion ratio for reasons other than standard anti-dilution provisions.[3] Paragraph 3 of APB 14 specifies that the terms of convertible instruments discussed therein "generally include…a conversion price which does not decrease except pursuant to antidilution provisions." However, conversion rate adjustment features generally have not caused issuers to conclude that their convertible debt instruments are not within the scope of paragraph 12 of APB 14 at issuance.[4]

7. APB 14 does not contain any discussion of debt instruments with an embedded conversion option that is indexed to the issuer's own stock but may be settled in cash at the issuer's option. Due to the absence of guidance in APB 14, the Task Force has discussed the accounting for certain cash-settleable convertible debt instruments at a number of previous meetings. Specifically, Issue 90-19 provides accounting and earnings per share guidance for three types of structured convertible debt instruments with the following characteristics:

Instrument A: Upon conversion, the issuer must satisfy the obligation entirely in cash based on the fixed number of shares multiplied by the stock price on the date of conversion (the conversion value).

Instrument B: Upon conversion, the issuer may satisfy the entire obligation in either stock or cash equivalent to the conversion value.

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

[3] Certain common contingent conversion rate adjustment features, including "make-whole" provisions, are described in more detail later in this memorandum.

[4] If the terms of a conversion rate adjustment feature cause the embedded conversion option to be indexed to an underlying other than the issuer's own stock, the conversion option would be separately accounted for as a derivative (provided that the criteria for separation in paragraph 12 of FAS 133 are met). Additionally, if the conversion option is not separately accounted for as a derivative, conversion rate adjustment features could subsequently trigger the recognition of a contingent beneficial conversion feature under Issues 98-5 and 00-27.

conversion spread (the excess conversion value over the accreted value) in either cash or stock.

8. At the May 9, 1991 EITF meeting, the Task Force reached a consensus that Instrument B should be accounted for as conventional convertible debt (that is, pursuant to the guidance in paragraph 12 of APB 14). However, they reached a consensus that Instruments A and C should be accounted for similar to indexed debt obligations, whereby the issuer adjusts the carrying amount of the instrument each period to the current conversion value, but not below the accreted value of the instrument. The consensus on Instrument A was subsequently nullified by FAS 133, because the embedded conversion option in that instrument is cash-settled and must be separately accounted for as a derivative. At the January 23–24, 2002 EITF meeting, the Task Force revised its original consensus in Issue 90-19 to specify that Instrument C should be accounted for like convertible debt (pursuant to the guidance in paragraph 12 of APB 14) if the conversion spread meets the requirements of Issue 00-19. The Task Force also reached a consensus at that 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.

9. 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. In recent periods, an increasing number of issuers have been using the proceeds from the issuance of Instrument C bonds to fund share buybacks. Such financing strategies typically result in an immediate earnings per share improvement because outstanding common shares are reduced, there is no immediate dilutive earnings per share effect from the Instrument C bonds (which are typically issued out-of-the-money), and interest costs for financial reporting purposes are often two percent or less.

10. In recent periods, an increasing number of issuers have also been using the proceeds from the issuance of Instrument C bonds to fund the purchase of call options on their own shares. In many cases, entities that purchase call options on their own shares in connection with the issuance of convertible debt also issue written call options (for example, warrants) with a higher strike price. These financing strategies are often referred to as "written call spreads" or "call option overlays." Such strategies enable the issuer to minimize dilution upon conversion by economically hedging the potential future issuance of shares at conversion and/or synthetically increasing the effective conversion price to an amount in excess of the conversion price that the issuer could attain solely from issuing convertible debt. Those strategies also enable the issuer to integrate the two instruments for tax purposes, resulting in a tax deduction that is similar to the entity's nonconvertible debt rate. Notwithstanding the existence of contractual linkage between the purchased call options and the convertible debt instruments (the issuer is required to exercise the purchased call options when the debt is converted), such instruments have not been linked for accounting purposes. That is, the convertible debt and the call options have not been accounted for on a combined basis as convertible debt issued at a discount to its par value. Rather, issuers have accounted for the convertible debt under paragraph 12 of APB 14 and have recognized the net premium paid for the call options in equity pursuant to Issue 00-19.

11. Prior to the Issue 90-19 consensus revision in January 2002, 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 appropriately reflects the economics of those instruments. Additionally, the use of proceeds from Instrument C bonds to fund share buybacks without recognizing the economic financing cost of those debt instruments enables issuers to generate immediate earnings per share increases. Without transparent disclosure that the earnings per share increases resulting from those financing strategies are attributable to the issuer's decision to finance a share buyback with low-coupon convertible debt that is not immediately reflected in diluted earnings per share calculations, investors could misinterpret the reasons for such increases. In response to certain of these concerns, Issue 07-2 was added to the Task Force's

agenda and, at the March 15, 2007 EITF meeting, the Task Force was asked to discuss whether convertible debt instruments that require or permit partial cash settlement upon conversion are within the scope of APB 14.

12. At the March 15, 2007 EITF meeting, a number of Task Force members raised concerns about the specific issue that the Task Force was being asked to consider. Some Task Force members suggested that the Task Force should address the diluted earnings per share treatment of convertible debt instruments that require or permit partial cash settlement upon conversion, rather than the accounting treatment. Some other Task Force members observed that the EITF's historical practice of addressing specific instruments and transactions has contributed to the complexity in accounting for financial instruments with characteristics of liabilities and equity. Accordingly, instead of addressing convertible debt instruments that require or permit partial cash settlement, which would primarily address the accounting for convertible debt with the characteristics of Instrument C, those Task Force members suggested that it would be more appropriate for the EITF to broadly address the scope of APB 14. Additionally, some other Task Force members suggested that the Task Force should undertake a broad, longer-term project to reconsider all EITF Issues that address the accounting for convertible debt, with the objective of reducing complexity in financial reporting. To address these concerns, the Task Force requested that the FASB staff form a working group to discuss (a) the scope of this Issue, (b) diluted earnings per share considerations, and (c) other potential short-term improvements to the accounting for convertible instruments.

Working Group Discussion

<u>Scope of Issue 07-2</u>

13. The Working Group recommended that Issue 07-2 be structured as an interpretation of the scope of APB 14, rather than as an Issue addressing the accounting for convertible debt instruments with certain characteristics (for example, Instrument C). Pursuant to that recommendation, the Task Force will be asked to discuss the following questions:

a. What is the scope of the guidance in paragraph 12 of APB 14?

b. What is the appropriate accounting model for convertible debt instruments that are not subject to the guidance in paragraph 12 of APB 14?

14. At the June 14, 2007 EITF meeting, the Task Force will be asked to discuss the first question, and, at a future meeting, the Task Force will be asked to discuss the second question. When the guidance in paragraph 12 of APB 14 does not apply to a convertible debt instrument, paragraph 18 of APB 14 requires that the instrument be accounted for in accordance with its substance. Possible alternative methods of accounting for such instruments that might be considered by the Task Force at a future meeting are described later in this Working Group Report. In connection with its discussion of Issue 2 at a future meeting, the Task Force will also have the opportunity to consider whether convertible debt instruments with beneficial conversion features should continue to be accounted for pursuant to the guidance in Issues 98-5 and 00-27, or whether such instruments should be accounted for based on the model developed in that Issue.

Diluted Earnings per Share Considerations

15. The Working Group discussed the diluted earnings per share treatment of convertible debt instruments that require or permit partial cash settlement upon conversion, as set forth in Issue 90-19, and concluded that such guidance is consistent with FAS 128. Accordingly, the Working Group recommended that the Task Force should not address the earnings per share treatment of such instruments. Pursuant to the Working Group's recommendation, the Task Force will not be asked to discuss the earnings per share treatment of convertible debt instruments that require or permit partial cash settlement upon conversion at the June 14, 2007 EITF meeting.

Other Potential Short-Term Improvements to the Accounting for Financial Instruments with Characteristics of Liabilities and Equity

16. A number of Working Group members expressed concern over the number of restatements relating to the accounting for financial instruments with characteristics of liabilities and equity. Some broad categories of such restatements relate to the identification of embedded derivatives under FAS 133, application of the classification guidance in Issue 00-19, and accounting for instruments with beneficial conversion features under Issues 98-5 and 00-27. Certain of those Working Group members suggested that the Task Force undertake a project to address those

practice issues in an effort to reduce complexity in accounting for financial instruments with characteristics of liabilities and equity.

17. The Working Group agreed that a longer-term initiative to reduce such complexity would improve financial reporting. However, some Working Group members indicated that those improvements are already being undertaken in connection with the FASB's liabilities and equity project. Additionally, some Working Group members observed that such a broad-based project would be significantly different in nature and scope from Issue 07-2 and should be submitted as a separate EITF agenda request.

18. The Working Group recommended that Issue 07-2 **not** be expanded into a broad-based project to reconsider existing EITF Issues on accounting for financial instruments with characteristics of liabilities and equity. Additionally, a majority of Working Group members recommended that a separate issue to address practice issues in applying Issue 00-19 be submitted separately to the EITF Agenda Committee as an agenda request. Pursuant to the Working Group's recommendation, Issue 07-2 has not been expanded to reconsider existing EITF Issues on accounting for financial instruments with characteristics of liabilities and equity. Additionally, a separate agenda request will be submitted to the EITF Agenda Committee relating to practice issues in applying Issue 00-19.

Accounting Issues and Alternatives

Issue 1: What is the scope of the guidance in paragraph 12 of APB 14?

View A (current practice) – The guidance in paragraph 12 of APB 14 applies at issuance to all convertible debt instruments except in the following circumstances:

a. The conversion option is required to be separately accounted for at fair value as a derivative pursuant to the guidance in FAS 133.

b. The convertible debt instrument contains a beneficial conversion feature that must be separately accounted for in equity pursuant to the guidance in Issues 98-5 and 00-27.

c. *The convertible debt instrument is issued at a substantial premium and some portion of the proceeds is allocated to paid-in capital pursuant to the guidance in paragraph 18 of APB 14.*

d. *The convertible debt instrument in its entirety is reported at fair value with changes in fair value recognized in earnings pursuant to the issuer's election of the fair value option under FAS 155 or FAS 159.*

e. *The conversion option embedded in a debt instrument can be legally detached and separately exercised.*

19. If the Task Force is unable to reach a consensus on Issue 1, the practical effect is the same as a consensus on View A because that view is consistent with current practice. **Consequently, those who believe Issue 07-2 should be dropped from the EITF's agenda altogether are proponents of View A.**

20. View A proponents believe that paragraph 12 of APB 14 applies to all convertible debt instruments unless (a) other applicable GAAP requires or permits an alternative accounting treatment (Items a – d above) or (b) the conversion option can be legally detached and separately exercised in a manner similar to a freestanding warrant (Item e above). View A proponents believe that, while paragraph 18 of APB 14 specifies that certain convertible debt instruments may not be subject to the guidance in paragraph 12 of that Opinion, Items a – d above already interpret paragraph 18 by requiring or permitting an alternative accounting treatment for convertible debt instruments with certain characteristics. In the absence of specific authoritative guidance to the contrary or an explicit provision that provides for the embedded conversion option to be legally detached and separately exercised, those proponents believe that the guidance in paragraph 12 of APB 14 should be applied.

21. View A proponents acknowledge that the guidance in paragraph 12 of APB 14 reduces comparability between issuers of convertible debt and nonconvertible debt because it requires convertible debt issuers to ignore the economic value of the embedded conversion option and recognize interest cost based on the cash interest coupon (for instruments issued at par). However, those proponents believe that the FASB's liabilities and equity project is the

appropriate mechanism to address that lack of comparability and to determine the appropriate accounting treatment for all convertible debt instruments, whether that may be a separation model or a fair value model. Those proponents observe that this Issue could potentially require a convertible debt issuer that currently recognizes interest cost based on the cash interest coupon, to begin recognizing interest cost based on their nonconvertible debt rate upon adoption of this Issue, and then to potentially recognize the same convertible debt instrument at fair value each period after adoption of a final standard under the liabilities and equity project. View A proponents believe that continued lack of comparability among issuers of convertible debt and nonconvertible debt for the next several years is preferable to a course of action that could potentially require convertible debt issuers to change their accounting treatment twice within a few years. Therefore, View A proponents believe that the scope of the guidance in paragraph 12 of APB 14 that has developed in practice over the past 38 years should be retained until the issuance of a final statement under the FASB's liabilities and equity project.

View B: The guidance in paragraph 12 of APB 14 applies at issuance to all convertible debt instruments except in the following circumstances:

a. *The conversion option is required to be separately accounted for at fair value as a derivative pursuant to the guidance in FAS 133.*
b. *The convertible debt instrument contains a beneficial conversion feature that must be separately accounted for in equity pursuant to the guidance in Issues 98-5 and 00-27.*
c. *The convertible debt instrument is issued at a substantial premium and some portion of the proceeds is allocated to paid-in capital pursuant to the guidance in paragraph 18 of APB 14.*
d. *The convertible debt instrument in its entirety is reported at fair value with changes in fair value recognized in earnings pursuant to the issuer's election of the fair value option under FAS 155 or FAS 159.*
e. *The conversion option embedded in a debt instrument can be legally detached and separately exercised.*
f. ***Upon conversion, the issuer is entitled to satisfy the if-converted value (or any portion thereof) in cash.***

22. View B is similar to the scope of Issue 07-2 as set forth in Issue Summary No. 1. However, at the March 15, 2007 EITF meeting, the Task Force was asked to consider whether convertible debt instruments that require or permit **partial** cash settlement upon conversion are within the scope of APB 14. View B in this Working Group Report would also apply to a convertible debt instrument that permits the issuer, upon conversion, to satisfy the **entire** obligation in either stock or cash equal to the conversion value (referred to as Instrument B in Issue 90-19). The types of convertible debt instruments that would be affected by a View B consensus include Instruments B and C in Issue 90-19, as well as convertible debt instruments that provide the issuer with the ability to settle investor conversions in any combination of shares and cash (such instruments are often referred to as "Instrument X").

23. View B proponents observe that paragraph 18 of APB 14 specifies that convertible debt instruments not **explicitly discussed** in that Opinion should be dealt with in accordance with the substance of the transaction. Those proponents observe that APB 14 makes no reference to convertible debt instruments that can be cash-settled upon conversion; that is, such instruments are not explicitly discussed therein. They believe that the principle behind the discussion in paragraph 18 is that the guidance in paragraph 12 should not be applied by analogy to instruments other than convertible debt that will either be repaid for cash at maturity or converted into shares of the issuer's stock.

24. View B proponents observe that the conclusion in APB 14 on the accounting for convertible debt was partly based on the mutual exclusivity 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 believe that that rationale is not applicable to many convertible debt instruments that may be cash settled upon conversion because the holder may receive both repayment of the debt instrument and net-share settlement of the conversion option. Accordingly, View B proponents believe that issuers of convertible debt instruments that may be cash-settled upon conversion are not subject to the guidance in paragraph 12 of APB 14. Additionally, proponents of View B observe that the diluted earnings per share treatment of many convertible debt instruments that may be cash settled upon conversion (such as 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 revised consensus in Issue 90-19 often results in circumstances in which a convertible debt instrument is treated like convertible debt for accounting purposes but is reflected in the issuer's diluted earnings per share calculations in a manner that is consistent with debt issued with detachable warrants.

25. Opponents of View B observe that, upon conversion, the economic value received by the holder is the same regardless of whether the consideration is paid in cash, shares of stock, or some combination thereof. Accordingly, those opponents believe the form of settlement does not embody a substantive economic difference that should warrant a dramatically different accounting treatment.

26. Proponents of View B observe that the existence in the marketplace of both (a) convertible debt instruments that permit cash settlement upon conversion and (b) convertible debt instruments that require physical share settlement upon conversion demonstrates that issuers and/or holders identify some economic distinction between instruments with differing settlement methods. Those proponents also observe that there is frequently a significant distinction between physically-settled convertible debt and certain convertible debt instruments that permit cash settlement upon conversion when determining the appropriate diluted earnings per share treatment. Additionally, View B proponents observe that, under existing GAAP, the form of settlement is often an important factor in determining an instrument's accounting treatment. For example, a conversion option embedded in a convertible debt instrument that is **required** to be settled in cash upon conversion is separately accounted for as a derivative under FAS 133. Therefore, View B proponents believe that it is appropriate to conclude that convertible debt instruments that may be cash-settled (in part or in whole) upon conversion are not subject to the guidance in paragraph 12 of APB 14.

View C: The guidance in paragraph 12 of APB 14 applies at issuance to all convertible debt instruments except in the following circumstances:

a. *The conversion option is required to be separately accounted for at fair value as a derivative pursuant to the guidance in FAS 133.*

b. *The convertible debt instrument contains a beneficial conversion feature that must be separately accounted for in equity pursuant to the guidance in Issues 98-5 and 00-27.*

c. *The convertible debt instrument is issued at a substantial premium and some portion of the proceeds is allocated to paid-in capital pursuant to the guidance in paragraph 18 of APB 14.*

d. *The convertible debt instrument in its entirety is reported at fair value with changes in fair value recognized in earnings pursuant to the issuer's election of the fair value option under FAS 155 or FAS 159.*

e. *The conversion option embedded in a debt instrument can be legally detached and separately exercised.*

f. ***Upon conversion, the issuer is entitled to satisfy the if-converted value (or any portion thereof) in cash.***

g. ***The conversion rate may be adjusted for reasons other than standard anti-dilution provisions. Standard anti-dilution provisions are those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction (as defined in the glossary of FAS 123(R)[5]) that are designed to maintain the value of the conversion option.***

27. View C is a narrow interpretation of the applicability of paragraph 12 of APB 14. There are a number of features commonly found in many convertible debt instruments that could result in an adjustment to the conversion rate for reasons other than equity restructurings (as defined in FAS 123(R)). Examples of certain conversion rate adjustment features are as follows:

a **Make-whole provisions**—If an issuer is acquired in a transaction with a significant cash component, the investor has the right to convert and receive additional shares as compensation for the lost option time value. The number of additional shares received by the holder is typically set forth in a table in the prospectus and is calculated based on the date that the merger occurs and the issuer's stock price at that time. The FASB staff

[5] FAS 123(R) defines an equity restructuring as "a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend."

understands that make-whole provisions are standard terms in the majority of convertible debt issuances. Such provisions are also sometimes applicable when an issuer calls a convertible debt instrument before a specified date.

b **Ordinary dividends—**Some convertible debt instruments provide for adjustments to the conversion rate upon the payment of any dividend.[6]

c **Registration payment arrangements—**Some convertible debt instruments provide for an increase to the conversion rate if the issuer has not successfully registered the underlying shares within a specified time period.

d **Conversion rate adjustment upon market triggers—**Some convertible debt instruments provide for adjustments to the conversion rate upon the attainment of specified stock price thresholds.

e **Time-adjusted conversion rate—**Some convertible debt instruments have a conversion rate that adjusts with the passage of time.

f **Adjustments for subsequent issuances—**Some convertible debt instruments (often issued by nonpublic venture-backed entities) contain provisions that reset the conversion rate of an instrument if the issuer subsequently issues convertible instruments with a more favorable conversion rate.

g **Other instrument-specific adjustments—**Various other contingent conversion price adjustments are described in Issues 98-5 and 00-27.

28. View C proponents observe that the guidance in paragraph 12 of APB 14 reduces comparability among issuers of convertible debt and nonconvertible debt. Even among issuers of convertible debt, APB 14 reduces comparability because some instruments contain more valuable conversion options than others and, therefore, have a different degree of impact on the coupon rate of interest. The lack of comparability resulting from the guidance in paragraph 12 of APB 14 is discussed in the dissent to that Opinion as follows:

> …by ignoring the value of the conversion privilege and instead using as a measure solely the coupon rate of interest, [APB 14] specifies an accounting treatment which does not reflect the true interest cost. The resulting error can be demonstrated by two issuers—one with a prime credit rating, so that it can obtain

[6] The earnings per share treatment of such features is addressed in Issue 2(b)(i) of Issue 03-6.

> financing by means of non-convertible debt; the other with an inferior credit rating, so that it can obtain financing at an acceptable rate only by means of a conversion option added to its debt. The coupon rate of interest of the prime rated issuer may be the same as, or higher than, the rate on the convertible debt of the other issuer. To conclude under these conditions, as the Opinion does, that the cost of this financing for the prime rated issuer is equal to or greater than that of the inferior rated issuer is to belie economic reality. Furthermore, while the debt obligation and the conversion feature coexist in a hybrid instrument, such fact is not a logical reason for failing to account separately for their individual values.

29. View C supporters observe that convertible debt instruments have grown increasingly complex and financial structuring has become more sophisticated since the issuance of APB 14. Those supporters believe that the discussion in paragraph 18 of APB 14 was intended to prevent issuers from applying the guidance in paragraph 12 to more complex convertible debt instruments. View C supporters observe that paragraph 3 of APB 14 indicates that the terms of convertible debt instruments discussed therein generally include a conversion price that does not decrease except for antidilution provisions. Notwithstanding that guidance, those supporters observe that practice has continued to apply paragraph 12 of APB 14 to convertible instruments with a conversion rate that may be adjusted for reasons other than antidilution provisions.

30. View C proponents believe that because APB 14 does not reflect the economic financing cost of issuing convertible instruments and reduces comparability, such guidance should be narrowly applied. View C proponents acknowledge that requiring issuers to account for the economic substance of convertible debt instruments is likely to increase complexity from the perspective of financial statement preparers. However, those proponents believe such a result is an inevitable consequence of improving comparability because it is likely not possible to develop an accounting model for convertible debt that is less complex to apply than the guidance in paragraph 12 of APB 14, which ignores the conversion option altogether. View C proponents observe that approximately 115 (23 percent) of the S&P 500 companies have convertible debt instruments outstanding at the present time. Among those entities, approximately 20 issuers are reporting interest cost at a rate of 1 percent or less and a number of those entities are reporting interest cost of zero on their convertible debt.[7] Based on the pervasiveness of convertible debt

[7] Source: *Convertibles and S&P Earnings*, UBS Investment Research, March 1, 2007.

instruments in the marketplace today, View C proponents believe immediate action should be taken to better reflect the economics of those instruments in financial statements.

Issue 2 (to be discussed at a future EITF meeting): What is the appropriate accounting model for convertible debt instruments that are not subject to the guidance in paragraph 12 of APB 14?

31. If a tentative conclusion based on View B or View C is reached on Issue 1, the Task Force will be asked to discuss Issue 2 at a future meeting. Because Issue 2 will not be discussed at the June 14, 2007 EITF meeting, this Working Group Report does not provide a detailed analysis of the alternative views on accounting for instruments that are not subject to the guidance in paragraph 12 of APB 14. When the guidance in paragraph 12 of APB 14 does not apply to a convertible debt instrument, paragraph 18 of APB 14 requires that the instrument be accounted for in accordance with its substance. For informational purposes, possible alternative methods of accounting for the substance of such instruments that might be considered by the Task Force at a future meeting are as follows:

a. *Separately account for the liability and equity components in a manner that reflects the issuer's economic interest cost.* This accounting model requires that an issuer first determine the fair value of a similar liability 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. This separation methodology is consistent with IAS 32 for convertible debt instruments that contain liability and equity components under that standard. A detailed description of the accounting treatment under this model (including initial measurement, subsequent measurement, modifications, and settlements) is described in Exhibit 07-2A of Issue Summary No. 1.
b. *Separately account for the liability and equity components in a manner that measures the equity component at its fair value upon issuance.* This accounting model requires that an issuer first determine the fair value of the embedded conversion option. The carrying amount of the liability is then determined by deducting the fair value of the equity

component from the initial proceeds ascribed to the convertible instrument as a whole. This separation methodology is consistent with FAS 133 for convertible debt instruments that are separately accounted for as derivatives under that standard. However, unlike embedded conversion options that are separately accounted for as derivatives under FAS 133, the conversion option would not be adjusted to its fair value in subsequent periods. Under this method, the reported interest cost on the liability component is likely to be similar (but not equal) to the interest cost for a similar liability that does not have an associated equity component. The accounting treatment under this approach is similar to the model described in Exhibit 07-2A of Issue Summary No. 1, except the method of separation between the liability and equity components at initial recognition and the method of allocation between the liability and equity components at settlement would differ.

c. *Account for the convertible debt instrument at fair value each reporting period.* This accounting model requires that an issuer account for the convertible debt as a combined instrument (no separation) at fair value each reporting period with changes in fair value recognized in earnings. This accounting treatment is consistent with the treatment under current U.S. GAAP in circumstances in which an issuer elects the fair value option for its convertible debt pursuant to the guidance in FAS 155 and FAS 159. This treatment is similar to the original consensus on Instrument C in Issue 90-19 because changes in the carrying amount of the instrument caused by changes in the issuer's stock price are recognized in earnings. Additionally, a requirement to measure convertible instruments that are not subject to the guidance in paragraph 12 of APB 14 at fair value is consistent with the FASB Board's long-term measurement objective of accounting for all financial assets and financial liabilities at fair value.

32. If a tentative conclusion on View B or View C is reached on Issue 1, the staff would welcome input at the June 14, 2007 EITF meeting regarding other possible alternative methods of accounting for convertible debt instruments that are not subject to the guidance in paragraph 12 of APB 14 to assist in preparing Issue 2 for discussion at a future meeting.

33. In connection with Issue 2, the Task Force will also be asked whether convertible debt instruments with beneficial conversion features should continue to be accounted for pursuant to

the guidance in Issues 98-5 and 00-27, or whether such instruments should be accounted for based on a different model (such as one of the approaches described in the preceding paragraph).

International Convergence

34. IFRS does not have a standard that is consistent with the guidance in paragraph 12 of APB 14. Additionally, the requirements for equity classification in U.S. GAAP (Issue 00-19) differ from the requirements for equity classification in IFRS (IAS 32). Consequently, this Issue does not provide an opportunity for significant international convergence. However, depending on the Task Force's decisions on Issues 1 and 2, there could be a limited group of convertible debt instruments that might be accounted for in a manner consistent with the guidance in IAS 32.

Interaction with Other Board Agenda Projects

35. 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.

36. 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 August 2007. At its May 8, 2007 meeting, the Board decided that the "ownership" approach will be characterized as its preferred approach in that Preliminary Views document. Under the ownership approach, convertible debt is accounted for at fair value each reporting period with changes in fair value recognized in earnings.

37. The Preliminary Views 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 to have an effective date any earlier than January 1, 2012 for calendar year-end companies.

Transition and Effective Date

38. At the June 14, 2007 EITF meeting, the Task Force will be asked to discuss Issue 1. If a tentative conclusion on View B or View C is reached on Issue 1, the Task Force will be asked to discuss Issue 2 at a future meeting. Alternatives for transition and effective date will be presented to the Task Force at that time; however, it is likely that the proposed effective date of this Issue would be for fiscal years beginning after December 15, 2008 (January 1, 2009 for calendar year-end companies).