

FASB Emerging Issues Task Force

Issue No. 06-7

Title: 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, *Accounting for Derivative Instruments and Hedging Activities*

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

Date prepared: October 25, 2006

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Date previously discussed: September 7, 2006

Previously distributed EITF materials: Issue Summary No. 1, dated August 10, 2006

References:

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

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

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

Statement 133 Implementation Issue No. K5, "Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues" (DIG Issue K5)

EITF Issue No. 98-5, "Accounting for 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 0-19)

*** 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.**

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

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

Background

1. At the September 7, 2006 EITF meeting, the Task Force reached a tentative conclusion on this Issue and directed the staff to pursue the issuance of a draft abstract for public comment. The draft abstract was posted to the website on September 26, 2006, with a comment period that ended October 13, 2006.

Formal Comments Received on the Draft Abstract

2. No comment letters were received on the draft abstract. At the November 16, 2006 EITF meeting, the Task Force will have the opportunity to redeliberate the elements of the tentative conclusion in the draft abstract and address the issues raised in this Issue Summary Supplement. The Task Force will then be asked to affirm the tentative conclusion as a consensus.

Other Comments Received on the Draft Abstract

3. The staff informally received a comment on whether Issue 06-7 should include guidance related to the accounting recognition for the conversion or extinguishment of an instrument for which the embedded conversion option has been reclassified to equity pursuant to the guidance in this Issue (an Issue 06-7 Instrument). The FASB staff believes that the general approach to accounting for the conversion or extinguishment of convertible debt instruments for which the conversion option is recognized in equity should be applied consistently, regardless of whether the amount recognized in equity is the intrinsic value of the conversion option at the commitment date (that is, for instruments with beneficial conversion features) or the fair value of the conversion option at the reclassification date (that is, for Issue 06-7 Instruments). For convertible debt instruments with beneficial conversion features, paragraph 21 of Issue 00-27 indicates that all of the unamortized discount remaining at the date of conversion should be immediately recognized as interest expense. Paragraph 35 of Issue 00-27 describes the Task Force's tentative conclusion that the portion of a debt instrument's reacquisition price that is allocated to a beneficial conversion feature in an extinguishment transaction is calculated based on the conversion option's intrinsic value at the extinguishment date. The staff has provided suggested guidance for the accounting for conversions and extinguishments of Issue 06-7 Instruments in the marked draft abstract (included in Exhibit 06-7A) that is generally consistent with the guidance in Issue 00-27 for conversions and extinguishments of instruments with

beneficial conversion features. However, the portion of the reacquisition price in a debt extinguishment transaction that is allocated to equity for an Issue 06-7 Instrument is determined based on its fair value at the extinguishment date (rather than its intrinsic value), because fair value is the measurement attribute for a conversion option embedded in an Issue 06-7 Instrument at its reclassification date.

Title: 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

Dates Discussed: September 7, 2006; [November 15–16, 2006]

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

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

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

Statement 133 Implementation Issue No. K5, "Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues"

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

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

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

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

~~EITF Issue No. 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues"~~

ISSUE

1. An entity may issue convertible debt with an embedded conversion option that is required to be bifurcated under Statement 133 if all of the conditions in paragraph 12 of that Statement are met. An embedded conversion option that initially requires separate accounting as a derivative under Statement 133 may subsequently no longer meet the conditions that would require separate accounting as a derivative. A reassessment of whether an embedded conversion option must be bifurcated under Statement 133 is required each reporting period. When an entity is no longer required to bifurcate a conversion option pursuant to Statement 133, there are differing views on how an entity should recognize that change.

¹ This draft abstract is being exposed for a public comment period that will end on October 13, 2006.

2. The issue is how an issuer should account for a previously bifurcated conversion option in a convertible debt instrument if that conversion option no longer meets the bifurcation criteria in Statement 133.

EITF DISCUSSION

3. The Task Force reached a [consensus] that an issuer should account for a previously bifurcated conversion option in a convertible debt instrument if the embedded conversion option no longer meets the bifurcation criteria in Statement 133 by reclassifying the carrying value of the liability for the conversion option (that is, its fair value on the date of reclassification) to shareholders' equity. Any debt discount recognized when the conversion option was bifurcated from the convertible debt instrument should continue to be amortized. If a holder exercises a conversion option that has previously been reclassified to shareholders' equity pursuant to the guidance in this Issue, the issuer shall recognize any unamortized discount remaining at the date of conversion immediately as interest expense. Alternatively, if a convertible debt instrument with a conversion option that has previously been reclassified to shareholders' equity pursuant to the guidance in this Issue is extinguished for cash (or other assets) prior to its stated maturity date, a portion of the reacquisition price shall be allocated to equity based on the fair value of the conversion option at the date of the extinguishment and the remaining reacquisition price shall be allocated to the extinguishment of the debt to determine the amount of gain or loss.

4. The Task Force discussed whether this consensus is inconsistent with Opinion 14 (which generally does not permit separate recognition of an embedded conversion option). The Task Force did not believe that the consensus on this Issue was inconsistent with Opinion 14 because the initial bifurcation was required pursuant to Statement 133. The Task Force believes that Opinion 14 only addresses the accounting at issuance for convertible debt instruments and does not address accounting for changes to convertible debt instruments subsequent to issuance. The Task Force also observed that the guidance in DIG Issue K5 does not apply to this Issue since it is specifically intended to address situations in which an embedded derivative is not required to be accounted for separately under Statement 133 as a result of newly issued Statement 133 implementation guidance.

Disclosure

54. The Task Force also reached a [consensus] that an issuer shall disclose the following information when an embedded conversion option previously accounted for as a derivative under Statement 133 no longer meets the separation criteria under that Statement:

- a. A description of the principal changes causing the embedded conversion option to no longer require bifurcation under Statement 133
- b. The amount of the liability for the conversion option reclassified to stockholders' equity.

Transition

65. The [consensus] in this Issue should be applied to all previously bifurcated conversion options in convertible debt instruments that no longer meet the bifurcation criteria in Statement 133 in interim or annual periods beginning after December 15, 2006, irrespective of whether the debt instrument was entered into prior or subsequent to the effective date of this Issue. Earlier

application of this Issue is permitted in periods for which financial statements have not yet been issued. Retrospective application pursuant to Statement 154 to previously issued financial statements is permitted.

Board Ratification

76. At its [November 29, 2006] meeting, the Board ratified the [consensus] reached by the Task Force on this Issue.

STATUS

87. No further EITF discussion is planned.