

FASB Emerging Issues Task Force

Issue No. 08-4

Title: Transition Guidance for Conforming Changes to Issue No. 98-5

Document: Issue Summary No. 1*

Date prepared: May 30, 2008

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

Date previously discussed: March 12, 2008

Previously distributed EITF materials: Proposed EITF Issue Clarification (Issue 98-5), dated November 29, 2007; Status Update and Other Related Matters (Issue 98-5), dated February 28, 2008

References:

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)

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

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

*** 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.**

Background

1. Certain consensuses in Issue 00-27 nullified portions of the guidance in Issue 98-5. A general status update that included transition guidance was added to Issue 98-5 to acknowledge the issuance of Issue 00-27. However, the portions of Issue 98-5 that were nullified by Issue 00-27 were not specifically identified in Issue 98-5, nor were the illustrative examples in Issue 98-5 updated for the effects of Issue 00-27.
2. In addition, FAS 150 was issued in May 2003. Instruments within the scope of FAS 150 are accounted for pursuant to the guidance in that Statement, not the guidance in Issues 98-5 and 00-27. A status update was added to Issue 00-27 clarifying that instruments within the scope of FAS 150 are no longer within the scope of Issue 00-27. However, a status update for FAS 150 was not included in Issue 98-5.
3. At the March 12, 2008 EITF meeting, the Task Force reached a consensus-for-exposure stating that the conforming changes that will be made to Issue 98-5 that resulted from Issue 00-27 and FAS 150 shall be effective for financial statements issued for fiscal years ending after December 15, 2008. The impact, if any, of applying the conforming changes shall be presented retrospectively with the cumulative-effect of the change being reported in retained earnings in the statement of financial position as of the beginning of the first period presented. The Task Force also directed the staff to pursue the issuance of a draft abstract for public comment. A draft abstract for this Issue was posted to the FASB website on April 1, 2008, with a comment period that ended on May 5, 2008.
4. The comment letter received on the draft abstract has been distributed to Task Force members and has been analyzed by the FASB staff. At the June 12, 2008 EITF meeting, the Task Force will have the opportunity to consider the comment letter as it redeliberates the consensus-for-exposure in the draft abstract. The Task Force will then be asked to affirm the consensus-for-exposure as a final consensus.

Formal Comment Received on the Draft Abstract

5. One comment letter was received on the draft abstract from an accounting organization. The respondent agreed with the Task Force's consensus-for-exposure.

6. The draft abstract is included in Appendix 08-4A. The staff believes that there are no issues or comments other than those that are editorial in nature that warrant consideration by the Task Force at the June 12, 2008 EITF meeting. [Added text is underlined and deleted text is ~~struck out~~.] The staff will ask the Task Force to approve the consensus-for-exposure as a final consensus at that meeting.

Title: Transition Guidance for Conforming Changes to Issue No. 98-5

Dates Discussed: March 12, 2008; {June 11–12, 2008}

References: FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
FASB Statement No. 154, *Accounting Changes and Error Corrections*
EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios"
EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments"

Objective

1. **The objective of this Issue is to provide transition guidance for conforming changes made to Issue 98-5 that resulted from Issue 00-27 and Statement 150.**

<p>All paragraphs in this Issue have equal authority. Paragraphs in bold set out the main principles.</p>
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Background

2. Certain consensuses in Issue 00-27 nullified portions of the guidance in Issue 98-5. A general status update that included transition guidance was added to Issue 98-5 to acknowledge the issuance of Issue 00-27. However, the portions of Issue 98-5 that were nullified by Issue 00-27 were not specifically identified in Issue 98-5, nor were the illustrative examples in Issue 98-5 updated for the effects of Issue 00-27.

3. In addition, Statement 150 was issued in May 2003. Instruments within the scope of Statement 150 are accounted for pursuant to the guidance in that Statement, not the guidance in Issues 98-5 and 00-27. A status update was added to Issue 00-27 clarifying that instruments within the scope of Statement 150 are no longer within the scope of Issue 00-27. However, a status update for Statement 150 was not included in Issue 98-5.

* ~~This draft abstract is being exposed for a public comment period that will end on May 5, 2008.~~

Scope

4. This issue applies to the conforming changes (included in Exhibit 08-4A) made to Issue 98-5 that resulted ed from Issue 00-27 and Statement 150.

Transition

5. Conforming changes made to Issue 98-5 that resulted from Issue 00-27 and Statement 150 shall be effective for financial statements issued for fiscal years ending after December 15, 2008. Early application is permitted. The impact, if any, of applying the conforming changes, ~~if any~~, shall be presented retrospectively with the cumulative-effect of the change being reported in retained earnings in the statement of financial position as of the beginning of the first period presented.

6. If as a result of applying the conforming changes in this Issue an entity has a change to its accounting, it shall comply with the disclosure requirements of Statement 154 for changes in accounting principles. Exhibit 08-4A includes the conforming changes made to Issue 98-5 relating to Issue 00-27 and Statement 150. [Added text is underlined and deleted text is ~~struck out~~.]

The provisions of this Issue need not be applied to immaterial items.

EITF ABSTRACTS

Issue No. 98-5

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

Dates Discussed: May 21, 1998; July 23, 1998; September 23–24, 1998; November 18–19, 1998; January 21, 1999; March 24–25, 1999; May 19–20, 1999; March 12, 2008

References: FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*
FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
FASB Statement No. 129, *Disclosure of Information about Capital Structure*
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*
FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity
FASB Statement No. 154, Accounting Changes and Error Corrections
FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*
APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
APB Opinion No. 20, *Accounting Changes*
APB Opinion No. 21, *Interest on Receivables and Payables*
APB Opinion No. 25, *Accounting for Stock Issued to Employees*
APB Opinion No. 26, *Early Extinguishment of Debt*
APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*
AICPA Accounting Interpretation, Interest on Receivables and Payables, of APB Opinion No. 21
SEC Staff Accounting Bulletin No. 68, *Increasing Rate Preferred Stock*
EITF Issue No. 85-17, "Accrued Interest upon Conversion of Convertible Debt"

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

EITF Issue No. 08-4, "Transition Guidance for Conforming Changes to Issue No. 98-5"

ISSUE

1. Entities may issue convertible debt securities and convertible preferred stock with a nondetachable conversion feature that is in-the-money at the commitment date¹ (a "beneficial conversion feature"). Those securities may be convertible into common stock at the lower of a conversion rate fixed at the commitment date or a fixed discount to the market price of the common stock at the date of conversion. Opinion 14 addresses an issuer's accounting for convertible debt with a nondetachable (embedded) conversion feature, the terms of which provide for (a) an initial conversion price that is greater than market value at the date of issuance and (b) a conversion price that does not decrease, except under antidilution protection. Opinion 14 does not explicitly address situations in which the embedded conversion feature is in-the-money at issuance, nor does it explicitly address convertible preferred stock.

2. Certain convertible securities may have a conversion price that is variable based on future events such as a subsequent round of financing at a price lower than the convertible securities' original conversion price, a liquidation or a change in control of the company, or an initial public offering at a share price lower than an agreed-upon amount. Opinion 14 also does not explicitly address situations in which the conversion terms are contingently adjustable.

¹~~The commitment date is the date when an agreement as to terms has been reached and the investor is committed to purchase the convertible securities based on those terms (that is, performance by the investor is probable because of sufficiently large disincentives for nonperformance). In certain cases, the securities may be purchased by a number of investors, such as a group of lenders participating in a syndicate. In those situations, the latest commitment date for the group or issuance date for each individual security, whichever comes first, should be considered the commitment date. The commitment date is defined as the date when an agreement has been reached with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:~~

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

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

The Task Force observed that if an agreement includes subjective provisions that permit either party to rescind its commitment to consummate the transaction (for example, a provision that allows an investor to rescind its commitment to purchase a convertible instrument in the event of a material adverse change in the issuer's operations or financial condition or a provision that makes the commitment subject to customary due diligence or shareholder approval), a commitment date should not occur until the provisions expire or the convertible instrument is issued, whichever is earlier. [Note: This consensus has been modified by Issue 4 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

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 obligation in either stock or cash. 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.

4. The issues are:

Issue 1—Whether embedded beneficial conversion features present in convertible securities should be valued separately at the commitment date

Issue 2—If the answer to Issue 1 is to value beneficial conversion features separately, then how an embedded conversion feature should be recognized and measured

Issue 3—How the issuance of convertible securities with beneficial conversion ratios that adjust (or arise) based on the occurrence of specified future events should be accounted for.

EITF DISCUSSION

5. The Task Force reached a consensus that embedded beneficial conversion features present in convertible securities should be valued separately at issuance. [Note: This consensus has been partially nullified by Statement 133 and Statement 150. See STATUS section.] The embedded beneficial conversion feature should be recognized and measured by allocating a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. That amount should be calculated at the commitment date² as the difference between the conversion price and the fair value³ of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible (intrinsic value).⁴

6. The Task Force observed that in certain circumstances, the intrinsic value of the beneficial conversion feature may be greater than the proceeds allocated to the convertible instrument. In those situations, the Task Force reached a consensus that the amount of the discount assigned to the beneficial conversion feature is limited to the amount of the proceeds allocated to the

²Refer to footnote 1.

³The fair value is the amount at which the common stock and/or other securities could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. That quoted price should not be adjusted to reflect transferability restrictions, large block factors, avoided underwriter's fees, or time value discounts. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances.

⁴In circumstances in which convertible securities are issued with detachable warrants, the Task Force noted that in order to determine the amount to be allocated to the beneficial conversion feature, the issuer must first allocate the proceeds between the convertible instrument and the detachable warrants using the relative fair value method of Opinion 14. A similar methodology would be used in circumstances in which convertible securities are issued along with another security, such as common stock.

convertible instrument. [Note: This consensus has been partially nullified by Statement 133. See STATUS section.] ~~Except as provided in paragraph 10 below, the discount assigned to the convertible instrument, if any, should be amortized over the period to the security's earliest conversion date. For convertible instruments that have a stated redemption date, a discount resulting from recording a beneficial conversion option shall be required to be amortized from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs. For convertible instruments that do **not** have a stated redemption date, such as perpetual preferred stock, a discount resulting from the accounting for a beneficial conversion option shall be amortized from the date of issuance to the earliest conversion date.~~ [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

7. The Task Force noted that, in accordance with Statement 129, the issuer should disclose in the footnotes to its financial statements the terms of the transaction, including the excess of the aggregate fair value of the instruments that the holder would receive at conversion over the proceeds received and the period over which the discount is amortized.

8. For convertible preferred securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature is analogous to a dividend and should be recognized as a return to the preferred shareholders ~~over the minimum period from the date of issuance to the date at which the preferred shareholders can realize that return (that is, through the date of earliest conversion)~~⁵ using the effective yield method. [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

9. For convertible debt securities, any recorded discount resulting from allocation of proceeds to the beneficial conversion feature should be recognized as interest expense ~~over the minimum period from the date of issuance to the date at which the debtholder can realize that return (that is, through the date of earliest conversion)~~⁶ using the effective yield method. [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

10. In situations in which the instrument incorporates a multiple-step discount (for example, an instrument that provides for a 15 percent discount to the market price after 3 months, a 25 percent discount after 6 months, a 35 percent discount after 9 months, and a 40 percent discount after 1 year), the basic accounting model described above is modified. For those types of convertible securities, the Task Force reached a consensus that the computation of the intrinsic value should be made using the conversion terms that are most beneficial to the investor. If the convertible instrument has a stated redemption date, the resultant discount should be amortized from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs (in the example noted above, the discount would be 40 percent and the amortization period would be from issuance to the stated redemption date). [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of

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

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

the STATUS section.]

10A. The resultant discount should beFor convertible instruments that do **not** have a stated redemption date, the resultant discount should be amortized over the minimum period in which the investor can recognize that return (in the example noted above, the discount would be 40 percent and the amortization period would be 1 year). [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.] However, amortization recognized may require adjustment to ensure that the discount amortized at any point in time is not less than the amount the holder of the instrument could obtain if conversion occurred at that date. That is, at the end of 3 months, at least the 15 percent discount should have been recognized. This method can be expressed as requiring cumulative amortization equal to the *greater of* (a) the amount derived using the effective yield method based on the conversion terms most beneficial to the investor or (b) the amount of discount which the investor can realize at that interim date.

11. In circumstances in which the instrument is converted prior to amortization of the full amount of the discount, the remaining unamortized discount at the date of conversion should be ~~included in the carrying value of the convertible security that is transferred to equity at the date of conversion.~~ immediately recognized as interest expense or as a dividend, as appropriate.^{6a} If the amount of unamortized discount is recognized as an expense (because the convertible instrument was in debt form), the expense should not be classified as extraordinary. [Note: This consensus has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.] If, however, the amount of discount amortized exceeds the amount the holder realized because conversion occurred at an earlier date, the Task Force agreed that no adjustment should be made to amounts previously amortized.

12. The Task Force also considered situations in which a debt instrument containing the embedded beneficial conversion feature is extinguished prior to conversion. The Task Force recognized that a portion of the reacquisition price includes a repurchase of the beneficial conversion feature. The Task Force reached a consensus that the amount of the reacquisition price to be allocated to the beneficial conversion feature should be measured using the intrinsic value of that conversion feature at the extinguishment date. The residual amount, if any, would be allocated to the convertible security. The Task Force indicated that the issuer would record a gain or loss on extinguishment of the convertible debt security. The Task Force observed that the gain or loss from the extinguishment of debt should be classified in accordance with the guidance in Statement 4. [Note: See STATUS section.] If the convertible instrument is a preferred security, guidance is provided in Topics No. D-42, "The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock," and No. D-53, "Computation of Earnings per Share for a Period That Includes a Redemption or an Induced Conversion of a Portion of a Class of Preferred Stock."

13. The Task Force also discussed the accounting for (a) a security that becomes convertible only upon the occurrence of a future event outside the control of the holder and (b) a security that

^{6a} For convertible debt that does not include a beneficial conversion option, Accounting Interpretation 1 of Opinion 26 and Issue 85-17 continue to apply. Those pronouncements state that the net carrying amount of the convertible debt, including any unamortized premium or discount, is credited to equity upon conversion.

is convertible from inception but contains conversion terms that change upon the occurrence of a future event. The Task Force reached a consensus that any contingent beneficial conversion feature should be measured ~~at~~ using the commitment date stock price but not recognized in earnings until the contingency is resolved.

14. The consensuses reached are applicable to instruments issued after May 20, 1999. Examples of the application of the above consensuses are in Exhibit 98-5A.

14A. Conforming changes made to Issue 98-5 relating to Issue 00-27 and Statement 150 shall be effective for financial statements issued for fiscal years ending after December 15, 2008, with early application permitted.^{6b} The impact, if any, of applying the conforming changes should be presented retrospectively with the cumulative-effect of the change being reported in retained earnings in the statement of financial position as of the beginning of the first period presented. [Note: See paragraphs 17A–18C and 19A–19C of the STATUS section.]

STATUS

15. Statement 133 was issued in June 1998 and has been subsequently amended. The effective date for Statement 133, as amended, is for all fiscal quarters of all fiscal years beginning after June 15, 2000.

16. The terms of the entire embedded conversion feature should be analyzed to determine whether it meets the criteria under paragraph 12 of Statement 133 to be separated from the host contract and accounted for as a derivative under that Statement. Paragraph 12(c) indicates that one criterion for separate accounting essentially is that the embedded derivative, as a freestanding instrument, would meet the definition of a derivative and be subject to Statement 133. Under paragraph 11(a) of Statement 133, contracts issued by the reporting entity that are both (1) indexed only to its own stock and (2) classified in stockholders' equity in its statement of financial position are not considered derivatives by that entity under Statement 133. However, the scope exception in paragraph 11(a) does not apply to the holder of a security convertible into the common stock of the issuer. Furthermore, the holder generally will conclude that the embedded conversion feature is not clearly and closely related to the host contract (refer to the criterion in paragraph 12(a)). Statement 155, which was issued in February 2006, amends Statement 133. Statement 155 provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. A hybrid financial instrument that is elected to be accounted for in its entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.

17. During the discussion of this Issue, it was mentioned that the issuer of those securities will generally be unable to reliably measure the fair value of the embedded beneficial conversion feature. The observation may be equally applicable to the holder of such securities. Paragraph 16 of Statement 133 states, "If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire

^{6b} Conforming changes were made to the following portions of Issue 98-5: footnote 1 to paragraph 1; paragraph 6; paragraph 8 and its related footnote 5; paragraph 9 and its related footnote 6; paragraphs 10, 10A, 11, 13, 17A, 18, 18B, 18C, 19A, 19B, and 19C; Cases 1(a), 1(b), 1(c), 1(d), 2, 3, 4, 5, and 6.

contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement." However, paragraph 301 of Statement 133 clarifies that it should be unusual that an entity would conclude that it cannot reliably separate an embedded derivative from its host contract.

17A. Issue 00-27 addresses a number of practice issues raised about the application of the Issue 98-5 model. The Task Force reached consensus on portions of Issue 00-27 at the November 15–16, 2000 meeting.

18. The original consensus reached in Issue 98-5 are applicable to instruments issued after May 20, 1999 and prior to November 16, 2000 (unless a commitment date, as defined under Issue 98-5, occurred before November 16, 2000, in which case Issue 98-5 applies to those instruments). For instruments issued after November 16, 2000, for which a commitment date, as originally defined in Issue 98-5, has not occurred prior to November 16, 2000, the consensus in Issue No. 00-27, "~~Application of Issue No. 98-5 to Certain Convertible Instruments~~," should be applied. Issue 98-5 originally defined a commitment date as the date when an agreement as to terms has been reached and the investor is committed to purchase the convertible securities based on those terms (that is, performance by the investor is probable because of sufficiently large disincentives for nonperformance). In certain cases, the securities may be purchased by a number of investors, such as a group of lenders participating in a syndicate. In those cases, the latest commitment date for the group or issuance date for each individual security, whichever comes first, should be considered as the commitment date.

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

18B. Cases 1(a), 1(b), 2, 3, 4, and 6 in Exhibit 98-5A have been amended to reflect the guidance provided in Issue 00-27.

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

19. Statement 145, issued in April 2002, supersedes Statement 4. Statement 4 required that all gains and losses from extinguishment of debt be classified as extraordinary items. Statement 145 removes the extraordinary item classification requirement but does not preclude gains and losses from extinguishment of debt that meet the criteria in Opinion 30 from being classified as extraordinary items.

19A. Statement 150 was issued in May 2003 and is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the interim period beginning after June 15, 2004, except for mandatorily redeemable financial

instruments of a nonpublic entity. Statement 150 establishes standards for issuer's classification and measurement of certain financial instruments with characteristics of both liabilities and equity, and requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances).

19B. Cases 1(c) and 5 in Exhibit 98-5A have been nullified as the instruments described in those examples are within the scope of Statement 150.

19C. At the March 12, 2008 meeting, the Task Force decided that Case 1(d) should be nullified as the instruments described in that example require an assessment of accounting literature that was issued subsequent to this Issue.

20. No further EITF discussion is planned.

Exhibit 98-5A

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUSES ON ISSUE 98-5

Case 1(a)—Instrument Is Convertible at Inception, Fixed Dollar Conversion Terms (Base Case)

Assumptions:

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

Calculation:

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

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

Entry at date of issuance:

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

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

⁷Convertible into 25,000 shares (1,000,000 ÷ 40) with an intrinsic value of \$10 (50 – 40) or overall: (1,000,000 ÷ 40) × (50 – 40).

Case 1(b)—Instrument Is *Not* Convertible at Inception, Fixed Dollar Conversion Terms (Base Case)

Assumptions:

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

Calculation:

FV at commitment date	\$50
Conversion price (stated and will not change)	\$40
Intrinsic value of beneficial conversion feature	\$250,000 ⁸
Amount to record over period to convert	\$250,000

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

Entry at date of issuance:

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

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

⁸ $(1,000,000 \div 40) \times (50 - 40)$

Case 1(e)—Instrument Is Convertible at Inception, Fixed Percentage Conversion Terms (Base Case)

Assumptions:

1. ~~\$1,000,000 of convertible debt.~~
2. ~~Convertible at date of issuance.~~
3. ~~Convertible at 80 percent of fair market value when converted.~~
4. ~~FV of common at commitment date equals \$50 per share.~~

Calculation:

FV at commitment date	\$50
Conversion price	\$40 ⁹
Intrinsic value of beneficial conversion feature	\$250,000 ¹⁰
Amount to record at issuance	\$250,000

In this case, the terms of the security change upon the occurrence of a future event (that is, the conversion price changes depending on the fair value of the common stock at the date of conversion). In this example, because the conversion percentage is fixed, the amount the investor will receive is *always* \$250,000. However, because the beneficial conversion feature is to be settled by issuing equity, the amount attributed to the beneficial conversion feature is recorded as a component of equity. Because the debt is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance.

Entry at date of issuance:

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

⁹50 × 80%

¹⁰(1,000,000 ÷ 40) × (50 — 40)

Case 1(d)—Instrument Is Convertible at Inception, Conversion Terms Are Not Fixed

Assumptions:

1. ~~\$1,000,000 of convertible debt.~~
2. ~~Convertible at date of issuance.~~
3. ~~Convertible at the lower of 80 percent of fair market value when converted or \$40.~~
4. ~~FV of common at commitment date equals \$50 per share.~~

Calculation:

FV at conversion date	<u>\$40</u>	<u>\$50</u>	<u>\$60</u>	<u>\$70</u>
80% of stock price at conversion date	\$32	\$40	\$48	\$56
Conversion price	\$32	\$40	\$40	\$40
Intrinsic value of beneficial conversion —feature at commitment date	\$250,000 ¹¹	\$250,000 ¹²	\$250,000 ¹³	\$250,000 ¹⁴

The beneficial conversion feature is calculated at its intrinsic value at the commitment date (that is, the difference between the conversion price and the fair value of the common stock into which the debt is convertible, multiplied by the number of shares into which the debt is convertible). A portion of the proceeds from issuance of the convertible debt, equal to the intrinsic value of \$250,000, is then allocated to additional paid-in capital. Because the debt is convertible at issuance, the debt discount is recorded as a charge to interest expense immediately. No additional amount would be recognized at the conversion date in recognition of an increase in the fair value of the stock conversion.

Entry at date of issuance:

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

¹¹~~(1,000,000 ÷ 40) × (50 — 40)~~

¹²~~(1,000,000 ÷ 40) × (50 — 40)~~

¹³~~(1,000,000 ÷ 40) × (50 — 40)~~

¹⁴~~(1,000,000 ÷ 40) × (50 — 40)~~

Case 2—Instrument Containing a Fixed Percentage Conversion Feature Dependent on a Future Event

Assumptions:

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

Calculation:

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

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

Entry at issuance:

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

Entry at IPO:

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

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

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

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

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

Case 3—Convertible Instrument Containing Fixed Terms That Change Based on a Future Event

Assumptions:

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

Calculation:

FV at commitment date	\$50
<u>Conversion price at commitment date</u>	<u>\$40</u>
Intrinsic value of basic beneficial conversion feature at commitment date	\$250,000 ¹⁸
<u>Conversion price at contingency resolution</u>	<u>unknown</u>
Most beneficial conversion price at — commitment date	\$30
Intrinsic value of contingent beneficial conversion feature at commitment date	<u>unknown</u> \$666,667 ¹⁹
Amount recorded at issuance date	<u>250,000</u>
Additional intrinsic value of contingent beneficial conversion — feature at commitment date	\$416,667

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

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

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

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

Entry at date of issuance:

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

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

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

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

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

Case 4—Conversion Dependent on a Future Event and Terms Are Variable

Assumptions:

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

Calculation:

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

²⁰ $(50 \times 115\%) \times 65\%$

²¹ $(1,000,000 \div 40) \times (50 - 40)$

²² $(1,000,000 \div 37.38) \times (57.50 - 37.38)$

The amount of the beneficial conversion feature is measured using the terms of the beneficial conversion feature that are operative at issuance, that is, the 20 percent discount. The intrinsic value of that beneficial conversion feature (\$250,000) is calculated at the commitment date and recorded at the issuance date. Because the debt is convertible at the date of issuance, the debt discount is charged to interest expense at the date of issuance has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

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

Entry at date of issuance:

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

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

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

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

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

~~Case 5 Fixed Percentage Conversion Price Based on a Range of Stock Prices in the Future~~

Assumptions:

- ~~1. \$1,000,000 of convertible debt.~~

²³~~\$538,256 — \$250,000~~

- ~~2. Convertible at date of issuance.~~
- ~~3. Convertible at 80 percent of the average stock price for the 30 days preceding the date of conversion.~~
- ~~4. FV of common at commitment date equals \$50 per share.~~
- ~~5. Average price per share for the 30 days preceding the commitment date equals \$45 per share.~~

Calculation:

FV at commitment date	\$50
80% of range preceding date — of issuance	\$36
Intrinsic value of beneficial conversion feature at — commitment date	\$388,889 ²⁴

~~The intrinsic value of the beneficial conversion feature is measured at the commitment date using facts available at that date. In this instance, the average stock price for the 30 day period preceding the commitment date is used in calculating the beneficial conversion feature. Because the security is immediately convertible, the intrinsic value of the beneficial conversion feature (\$388,889) would be charged to interest expense at issuance.~~

~~Entry at date of issuance:~~

Cash	\$1,000,000
Interest expense	388,889
— Debt	\$1,000,000
— APIC	388,889

Case 6—Extinguishment of Convertible Debt That Includes a Beneficial Conversion Feature

At the commitment date:

Proceeds from issuance of <u>zero coupon</u> convertible debt	\$100
Intrinsic value of beneficial conversion feature	\$90

At the commitment date, the issuer records \$90 as discount on the debt with the offsetting entry to additional paid-in capital. The remainder (\$10) is recorded as debt and is accreted to its full face value of \$100 over the period from the issuance date until the stated redemption date of the instrument (3 years)~~earliest conversion date~~. The debt is subsequently extinguished one year after issuance.

²⁴(1,000,000 ÷ 36) × (50 – 36)

At the extinguishment date:

Reacquisition price	\$150
Intrinsic value of beneficial conversion feature at extinguishment date	\$80
Carrying value of debt	<u>\$22²⁵</u> 100

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

Entry to record the extinguishment:

Debt	\$ 22 100	
Equity (paid-in capital)	80	
Loss on extinguishment	48	
Gain on extinguishment		\$30
Cash		150

[Note: This example has been amended by Issue 6 of Issue 00-27. See paragraphs 17A–18C of the STATUS section.]

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