

PROPOSED EITF ISSUE CLARIFICATION

Issue No. 98-5

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

Date Discussed: November 29, 2007

PURPOSE

The purpose of this memorandum is to inform the Task Force of a technical correction that the staff believes is required. Issue 98-5 addresses the accounting for convertible debt instruments and convertible preferred stock with nondetachable conversion features that are in-the-money at the commitment date. Issue 98-5 also addresses an issuer's accounting for convertible instruments that have conversion prices that are variable based on future events. The Task Force reached a consensus on Issue 98-5 in May 1999. Subsequent to the consensus, a number of issues about the application of the Issue 98-5 model arose.

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," was issued by the Task Force to address such application issues. In reaching the consensus on Issue 00-27, the Task Force modified portions of Issue 98-5. However, such modifications were never reflected in Issue 98-5 leaving inconsistencies between Issue 98-5 and Issue 00-27. The staff has proposed the following modifications to Issue 98-5 to eliminate such inconsistencies.

PROPOSED MODIFICATIONS

The following is a summary of the proposed modifications to Issue 98-5.

- Issue 4 of Part II of Issue 00-27 replaces the definition of commitment date in footnote 1 of Issue 98-5 with a definition that is consistent with the firm commitment definition in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
- Issue 98-5, paragraph 6, requires that the intrinsic value of a beneficial conversion feature be recognized and amortized over the period beginning on the date of issuance through the convertible instrument's earliest conversion date. However, Issue 6 of Part II of Issue 00-27

modifies the model in Issue 98-5 for convertible instruments that have a stated redemption date, to require a discount resulting from recording a beneficial conversion option 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. Issue 00-27 does not affect the model in Issue 98-5 for convertible instruments that do not have a stated redemption date.

- Issue 98-5, paragraph 11, requires that in circumstances in which the instrument is converted prior to amortization of the full amount of the discount, the remaining unamortized discount should be included in the carrying value of the convertible security that is transferred to equity at the date of conversion. However, Issue 6 of Part II of Issue 00-27 states that all of the unamortized discount remaining at the date of conversion should be immediately recognized as interest expense or as a dividend, as appropriate.

In addition to the proposed modifications to the EITF Discussion, the staff believes that the following modifications to the examples included in Exhibit 95-8A are required.

- Cases 1(a), 1(b), 2, and 6—These examples were modified to reflect the change in amortization period required by Issue 00-27 (amortization from the date of issuance through the stated redemption date of the instrument).
- Case 1(c)—This example has been deleted from Issue 98-5. The instrument described in this example is within the scope of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, as it embodies an unconditional obligation that the issuer may settle by issuing a variable number of its equity shares and the monetary value of the obligation is based solely on a fixed monetary amount that is known at the inception of the instrument.
- Case 1(d)—This example has been deleted from Issue 98-5. The instrument described in this example is complex and must be evaluated under multiple pieces of accounting literature in order to determine the proper accounting treatment (for example: APB Opinion No. 21, *Interest on Receivables and Payables*, Statement 133, Statement 150, and EITF Issues No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," and No. 01-6, "The Meaning of 'Indexed to

a Company's Own Stock"). Case 1(d) does not reflect the consideration of other accounting literature, and in order to update the example, the staff would be required to interpret the other accounting literature. The staff does not believe that Case 1(d) is the appropriate place to interpret that other accounting literature. Furthermore, the staff is aware that in practice, this example has created diversity as some preparers simply follow the accounting within this example, while others analyze other accounting literature along with this example when determining the proper accounting for such an instrument.

- Cases 3 and 4—These examples were modified to reflect the change in amortization period required by Issue 00-27 (amortization from the date of issuance through the stated redemption date of the instrument). Additionally, Issues 3 and 7 of Part II of Issue 00-27 provide guidance for contingent conversion features whose intrinsic value cannot be computed at the commitment date, while Issue 98-5 is silent on that situation. However, within the calculations in Cases 3 and 4 the intrinsic value of the contingent conversion feature is estimated at the commitment date, which is inconsistent with the explicit guidance in Issue 00-27. Therefore, while no modification is required in the EITF Discussion Section of Issue 98-5, modifications to Cases 3 and 4 are required.
- Case 5—This example has been deleted from Issue 98-5. The instrument described in this example is within the scope of Statement 150 as it embodies an unconditional obligation that the issuer may settle by issuing a variable number of its equity shares and the monetary value of the obligation is based predominantly on a fixed monetary amount that is known at the inception of the instrument. It should be noted that a similar instrument is included in paragraph A19 of Statement 150 as an example of a financial instrument included in that Statement's scope.

Finally, the staff believes that the following modifications to the Status section of Issue 98-5 are required.

- The Status section of Issue 98-5, paragraph 18, currently has limited information about the issuance of Issue 00-27 and its affect on Issue 98-5. Specifically, the Status section only discusses the transition guidance provided in Issue 00-27. The staff has modified the status

section of Issue 98-5, to discuss the general issuance of Issue 00-27 and the various ways it modifies Issue 98-5.

- Statement 150 was issued in May 2003; however, Issue 98-5 was not updated to reflect such issuance. The staff has modified Issue 98-5 to reflect the effect of Statement 150. Note that the status update is similar to the status update in Issue 00-27 for Statement 150.

For Task Force members' convenience, Appendix 98-5A to this memorandum includes a marked draft abstract to indicate the proposed changes to Issue 98-5. Note that the marked draft also includes staff comments, which will be removed from the published version of the abstract.

EITF ABSTRACTS (DRAFT*)

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

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. 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 1, *Debt Tendered to Exercise Warrants, of APB Opinion No. 26*
SEC Staff Accounting Bulletin No. 68, *Increasing Rate Preferred Stock*

ISSUE

1. Entities may issue convertible debt securities and convertible preferred stock with a

* This draft abstract was prepared to facilitate discussion of the guidance on which the Task Force reached its consensus and contains all substantive aspects of the consensus. The final abstract, which will be included in the next update for *EITF Abstracts*, may contain nonsubstantive editorial revisions.

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.

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

¹The commitment date is defined as an agreement 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. [Note: See STATUS section.]

~~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.~~

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. 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

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.

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 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: See 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: See 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~~

⁵~~For 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.~~

is, ~~through the date of earliest conversion⁶~~—using the effective yield method. [Note: See 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: See STATUS section.]

11. For 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). 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.

12~~4~~. 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

⁶~~For 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.~~

immediately recognized as interest expense or as a dividend, as appropriate.⁵ 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. ~~included in the carrying value of the convertible security that is transferred to equity at the date of conversion.~~ [Note: See 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.

132. 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.”

143. 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 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 the commitment date but not recognized in earnings until the contingency is resolved.

⁵ For convertible debt that does not include a beneficial conversion option, Accounting Interpretation 1 of Opinion 26 and Issue No. 85-17, "Accrued Interest upon Conversion of Convertible Debt," 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.

154. 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.

STATUS

165. 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.

176. 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.

187. 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 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.

198. Issue No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments,” addresses a number of practice issues raised about the application of the Issue 98-5 model. The Task Force reached a consensus on Issue 00-27 at the November 15–16, 2000 meeting.

20. Issue 4 of Part II of Issue 00-27 replaces the definition of commitment date in footnote 1 of Issue 98-5 with a definition that is consistent with the firm commitment definition in Statement 133.

21. Issue 6 of Part II of Issue 00-27 modifies the model in Issue 98-5 for convertible instruments that have a stated redemption date to require a discount resulting from recording a beneficial conversion option 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. The Task Force also modified Issue 98-5 for circumstances in which the instrument is converted prior to amortization of the full amount of the discount. Issue 00-27 requires that the unamortized discount remaining at the date of conversion be immediately recognized as interest expense or as a dividend, as appropriate.

22. 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 00-27 should be applied. 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.

2319.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.

2420.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).

25. A financial instrument that is convertible into a variable number of shares based solely or predominantly on a fixed monetary amount (that is, stock-settled debt) is within the scope of Statement 150. A provision in a financial instrument that requires (or permits at the issuer's discretion) settlement by issuance of a variable number of shares that have a value equal to a fixed monetary amount is not a conversion option for purposes of applying Issue 98-5. Rather, such provisions should be evaluated as redemption features under other applicable guidance (for example, Statement 150, Statement 133, and Opinion 21).

26. 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.~~ Because the debt 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

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.~~ Because the debt 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

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:

	<u>\$50</u>	<u>\$60</u>	<u>\$70</u>
IPO price			
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:

<u>Debt discount</u>	\$250,000	
Interest Expense		
APIC		\$250,000

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 <u>at commitment date</u>	\$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	unknown \$666,667 ¹⁹
Amount recorded at issuance date	250,000
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. Because the debt 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.~~

Entry at date of issuance:

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

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

Cash	\$1,000,000	
<u>Debt discount</u> 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.

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	<u>unknown</u> \$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	<u>unknown</u> \$538,256 ²²

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.~~ Because the debt has a stated

²⁰ $(50 \times 115\%) \times 65\%$

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

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

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..

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

~~Assumptions:~~

- ~~1. \$1,000,000 of convertible debt with a stated maturity of five years.~~
- ~~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:~~

~~²³\$337,613~~538,256~~ - \$250,000~~

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. Because the debt has a stated maturity of five years, the intrinsic value (\$388,889) 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
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 (three years). ~~earliest conversion date~~. The debt is subsequently extinguished one year after issuance.

At the extinguishment date:

Reacquisition price	\$150
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²⁴ $(1,000,000 \div 36) \times (50 - 36)$

Intrinsic value of beneficial conversion feature at extinguishment date	\$80
Carrying value of debt	<u>\$22⁷100</u>

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	\$22100	
Equity (paid-in capital)	80	
Loss on extinguishment	48	
Gain on extinguishment	30	\$30
Cash		150

⁷ 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.