MINUTES

Financial Accounting Standards Board

To: Board Members

From: Beckendorff, Ext. 229

Subject: Minutes of the March 14, 2007 Board Meeting—Statement 133 Implementation Issue, "Whether Embedded Conversion Options Are Indexed to both an Entity's Own Stock and Currency Exchange Rates" **Date:** March 27, 2007

cc: FASB: Smith, Bielstein, MacDonald, Leisenring, Golden, Fanzini, Wilkins, Stoklosa, Jacobs, Mayrhofer, Glotzer, Chookaszian, Polley, Gabriele, Carney, Allen, FASB Intranet

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic:	Statement 133 Implementation Issue, "Whether Embedded Conversion Options Are Indexed to both an Entity's Own Stock and Currency Exchange Rates"
Basis for Discussion:	Board Memorandum No. 1
Length of Discussion:	10:45 to 11:30 a.m.
Attendance:	
Board members present:	FASB: Batavick, Crooch, Linsmeier, Seidman, Trott, and Young IASB: Leisenring
Board members by phone:	Herz
Staff in charge of topic:	Fanzini
Other staff at Board table:	Stevens, Golden, Wilkins, Jacobs, and Beckendorff

Summary of Decisions Reached:

The Board discussed the issuance of proposed Statement 133 Implementation Issue, "Whether Embedded Conversion Options Are Indexed to both an Entity's Own Stock and Currency Exchange Rates." The Board decided:

1. Embedded conversion options in a convertible debt instrument denominated in a currency other than the issuer's functional currency **do not** meet the scope exception in paragraph 11(a) of Statement 133 (that is, the instrument is considered to be indexed to something else in addition to the entity's own shares) and, therefore, **must be separated** from the host contract and accounted for as a derivative.

2. Embedded conversion options in a convertible debt instrument denominated in the issuer's functional currency but convertible into shares traded only on non-functional currency exchanges **do** meet the scope exception in paragraph 11(a) of Statement 133 (that is, the instruments are considered to be indexed solely to the entity's own shares) and, therefore, **do not have to be separated** from the host contract and accounted for as a derivative.

3. If an entity determines that an embedded conversion option is required to be separately accounted for as a derivative instrument upon adoption of the guidance (as in Scenario 1 of this Issue), the embedded conversion option shall be measured at its fair value at the date of adoption and the debt host contract shall be measured at the accreted value that would have been recorded at that date if the embedded conversion option had been bifurcated at issuance. The difference between (a) the aggregate carrying amount of the embedded conversion option and the debt host immediately after adoption and (b) the carrying amount of the convertible debt instrument immediately prior to adoption shall be recognized as a cumulative effect adjustment to the opening balance of retained earnings (or other

appropriate components of equity or net assets in the statement of financial position).

4. If an entity determines that an embedded conversion option that was separately accounted for as a derivative instrument qualifies for the scope exception in paragraph 11(a) of Statement 133 upon adoption of the guidance (as in Scenario 2 of this Issue), the carrying amount of the liability for the conversion option (that is, its fair value) shall be reclassified to equity upon adoption. Any debt discount that was recognized when the conversion option was bifurcated from the convertible debt instrument should continue to be amortized.

5. The staff shall issue an exposure draft providing guidance on this issue. The effective date of the guidance in this proposed Statement 133 Implementation Issue for each reporting entity is the first day of the first fiscal quarter beginning after the Board-cleared guidance is posted on the FASB website. The guidance in this proposed Statement 133 Implementation Issue shall be applied to all transactions that the reporting entity enters into on or after that effective date. However, for all financial instruments and other transactions accounted for prior to the first fiscal quarter beginning after the Board-cleared guidance is posted on the FASB website, the effective date of this proposed Statement 133 Implementation Issue shall be the beginning of the reporting entity's first fiscal year beginning after the Board-cleared guidance is posted on the FASB website; early application of the guidance in this proposed Statement 133 Implementation Issue to those financial instruments and other transactions is not permitted.

Objectives of Meeting:

The objective of the meeting was for the Board to approve the issuance of proposed Statement 133 Implementation Issue, "Whether Embedded Conversion

Options Are Indexed to both an Entity's Own Stock and Currency Exchange Rates." That objective was met.

Matters Discussed and Decisions Reached:

6. Mr. Fanzini opened the discussion by stating that the purpose of today's meeting is for the Board to consider a recommendation to provide implementation guidance on evaluating whether an embedded conversion option in a convertible debt instrument qualifies for the scope exception provided in paragraph 11(a) of Statement 133.

Background

7. Mr. Fanzini provided the Board with a brief background of the issue. He noted that this issue originated from several technical inquires with similar fact patterns, and that although this issue has been raised in the context of a convertible bond, it applies equally to freestanding instruments including all contracts entered into by an entity to exchange a fixed number of its own shares for a fixed amount of cash that is denominated in a foreign currency. Such contracts can be simple forward agreements, non-employee stock options, or warrants.

8. Mr. Fanzini stated that paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument if certain criteria are met. One of those criteria, set forth in paragraph 12(c), is that a separate instrument with the same terms as the embedded derivative instrument would meet the definition a derivative. However, Paragraph 11(a) of Statement 133 specifies that contracts issued or held by the reporting entity that are both (a) indexed to its own stock and (b) classified in stockholders' equity in its statement of financial position shall not be considered to be derivative instruments for purposes of applying the Statement. Consequently, if the conversion option embedded in a convertible debt instrument meets the scope exception in paragraph 11(a) of Statement 133,

it would not be separated from the debt host contract and accounted for as a derivative.

9. Mr. Fanzini stated that there appears to be a diversity in practice as to whether foreign currency risk causes the embedded equity option, when analyzed on a freestanding basis, to no longer be considered indexed solely to that reporting entity's own stock. In other words, when is the embedded equity option dual indexed? He stated that there are two scenarios when this issue would arise.

Scenario 1

10. Mr. Fanzini stated that the first scenario considers a company who issues convertible debt indexed to its own stock that is denominated in a currency other than the company's functional currency. For example, Company A, whose functional currency is the U.S. dollar, issues convertible notes denominated in Euros with a par value of EU 1,000 per note. Each EU 1,000 par value note is convertible at any time into 100 shares of Company A's common stock

11. Mr. Fanzini stated that, for this scenario, the staff believes that the consideration received by the issuer upon conversion (that is, the exercise price of the conversion option) is the *debt host that is reacquired*. The fair value of the debt host is impacted by currency exchange rates; therefore, the embedded conversion option is dual-indexed to both the issuer's own stock and currency exchange rates and **does not** qualify for the 11(a) scope exception.

12. Mr. Fanzini stated that part of the staff's reasoning was that upon conversion, instead of paying a fixed strike, the convertible bond-holder surrenders the right to receive future bond cash flows. That is because, in effect, the option can only be exercised by surrendering the bond in lieu of cash. The fair value of the debt host that would be reacquired upon conversion is impacted by currency exchange rates, so the exercise price of the embedded conversion option in this example varies based on currency exchange rates. Pursuant to the

guidance in Implementation Issue C8, “Derivatives That Are Indexed to both an Entity’s Own Stock and Currency Exchange Rates,” a forward contract indexed both to an entity’s own stock and currency exchange rates would **not** be considered indexed to the issuer’s own stock. While the guidance in Implementation Issue C8 specifically discusses a forward contract, the same conclusion applies if the instrument that is indexed both to an entity’s own stock and currency exchange rates is an option contract (including an embedded conversion option).

13. Mr. Herz asked why this issue had come to the Board and why formal guidance was necessary. Mr. Fanzini answered that the FASB had received technical inquiries dating back to 2002 on this issue and that recent restatements involving this issue have led to a request for guidance from several accounting firms. Mr. Stevens added that the manner in which certain Asian countries access capital markets is causing this issue to arise more frequently.

14. Mr. Linsmeier stated that he would like the staff to perform further analysis before making a recommendation. He stated that he looked at the issue differently than the staff and that his way of thinking differentiated between stand-alone and embedded derivatives. Mr. Linsmeier stated that this issue involves an embedded derivative with two separate risks: a foreign currency risk and an equity price risk. He stated that the staff has based their decision to bifurcate the derivative by looking solely to paragraph 11(a), which only deals with the equity component of the risk. Mr. Linsmeier suggested looking at paragraph 12 in its totality when evaluating whether or not the embedded derivative should be bifurcated from the host. He stated that it is possible that the foreign currency risk in the embedded derivative might be considered “clearly and closely related” under 12(a). The remaining equity risk would then qualify under 12(c), which is pursuant to 11(a). Therefore, Mr. Linsmeier stated, by applying paragraph 12 in its totality, both risks (foreign exchange and equity price) qualify under 12(a) and 12(c), and the derivative does not need to be un-embedded.

15. Mr. Herz stated that, given the current literature, both the staff's and Mr. Linsmeier's viewpoints could be justified. He stated that the issue to him is the trade-off between improvement in one area of accounting (convertible debt) and added complexity in another (Statement 133). He stated that he preferred Mr. Linsmeier's way of thinking over the staff's because it made more sense economically. He noted that constituents already complain about the conflicting nature of Statement 133 when viewed in totality, and it would not make sense economically to say an equity option was indexed to foreign currency but not interest rates. Making that differentiation would only add complexity to Statement 133 and lead to "a bag of rules."

16. Mr. Golden asked Mr. Herz if his analysis would be the same if there was a free-standing derivative with an exercise price denominated in a currency different than the issuer's functional currency. Mr. Herz stated that his analysis would be different because embedded conversion options are treated differently than freestanding options. Mr. Herz stated that this may be a problem with the current literature.

17. Ms. Seidman stated that she still was not sure that the FASB should proceed with implementation guidance on this issue. She stated that she had initially agreed with the staff's recommendation, but Mr. Linsmeier's way of thinking added complexity to the issue. Ms. Seidman stated that Mr. Linsmeier's way of thinking could possibly be viewed as a "clean host" issue. If you look at the financial instrument as a debt instrument denominated in a foreign currency, there would not be an embedded derivative under paragraph 15, and FAS 52, *Foreign Currency Translation*, would provide guidance on how to account for transaction gains and losses. She stated that the question is, when you embed an 11(a)-type item in a financial instrument, do you evaluate it based on paragraph 11(a) or paragraph 15? She stated that she believes Mr. Linsmeier's way of thinking is valid and that she would prefer to defer making her decision on this issue.

18. Mr. Stevens gave an example of why freestanding and embedded options can be considered dual indexed. He stated that the issuer of a freestanding option is effectively short on their own stock, that is, they have a loss if their share price goes up. The issuer is also long on their currency, so the issuer could have a gain or loss regardless of the stock price, due to changes in currency. He stated that this phenomenon also happens if you take the option and embed it in a bond. A company's stock price could rise above the stated conversion price of the instrument, but the company might still have a gain if it reacquired a bond that was worth more than the shares issued due to changes in currency rates. Mr. Herz noted that the economic value of an option also moves when a regular convertible is converted due to interest rates. Mr. Stevens responded that Statement 133 clearly did not contemplate that the inherent indexation to interest rates or credit caused an embedded conversion option to fail 11(a), and neither does IAS 32. He stated that this draft DIG issue, "Whether Embedded Conversion Options Are Indexed to both an Entity's Own Stock and Currency Exchange Rates," clarifies this point, and it points out that other types of indexation that change the company's gain or loss, other than the stock price, would be factored in. Mr. Stevens stated that, from a convergence perspective, the IFRC has also concluded that, while the credits and interest rates don't taint the conversion option, if the currency of the bond is different than the company's functional currency, the conversion option is indexed to foreign currency.

19. Mr. Wilkins stated that he recognized the problem with interest and credit rates being clearly and closely related and stated that maybe these factors should have been included in a separate scope exception rather than buried in paragraph 61. He stated that he clearly thought that foreign currency would be considered outside the bounds of items that would not require bifurcation. Mr. Wilkins also stated that Mr. Linsmeier's viewpoint would be refuted by the language in paragraph 286.

20. Mr. Trott stated that he agreed with the staff recommendation. He stated that we have always recognized the idea that a change in value of one item is

impacted by changes in value of another (that is, interest rates, foreign currency, and credit), the fact that some are treated separately is a fact of Statement 133.

21. Mr. Young stated that he agreed with the staff recommendation because the outcome reflects the economics of the situation. He stated that he was not sure how Statement 133 leads to the staff's outcome and would not mind developing Mr. Linsmeier's idea.

22. Mr. Batavick agreed with the staff. He stated that he acknowledged the ambiguity within the literature, but stated that the staff's analysis and conclusions were consistent with his understanding of Statement 133.

23. Mr. Crooch agreed with the staff.

Scenario 2

19. Mr. Fanzini stated that the second scenario considers a company who issues convertible debt (indexed to its own stock) denominated in their own functional currency but indexed to stock that trades principally or exclusively in a foreign market. For example, Company A, whose functional currency is the U.S. dollar (US$), issues convertible notes denominated in US$ with a par value of US$1,000 per note. Each US$1,000 par value note is convertible at any time into 100 shares of Company A's common stock. Company A's common stock is publicly traded on a European stock exchange. Those shares are not traded on an exchange (or other established marketplace) on which trades are denominated in US$.

20. Mr. Fanzini stated that the staff believes that, for purposes of applying the scope exception in paragraph 11(a) of Statement 133, an option contract (including an embedded conversion option) with a fixed exercise price that would require an entity to issue a fixed number of its own equity shares upon exercise should not be considered indexed to an underlying other than the issuer's own stock solely because those equity shares are transacted between investors in a currency other than the issuer's functional currency.

21. Mr. Fanzini stated that in this scenario, the issuer is required to deliver a fixed number of shares in exchange for the reacquisition of a debt host instrument that is denominated in the issuer's functional currency. He stated that the fair value of the debt host is **not** impacted by currency exchange rates, so the exercise price of the embedded conversion option in this example is deemed to be fixed. (He noted that it is not necessary to consider an embedded conversion option's inherent indexation to interest rates and credit risk associated with the debt host for purposes of applying the scope exception in paragraph 11(a) of Statement 133).

22. Mr. Fanzini stated that **because neither the exercise price nor the number of shares issuable upon conversion varies** is based on an underlying, the embedded conversion option is considered to be indexed to the issuer's own stock. Mr. Fanzini noted that this analysis focuses on the exercise price of the conversion option instead of the foreign currency risk in foreign stocks.

23. Mr. Young stated that he agreed with the staff in that the paragraph 11(a) exception is met in this scenario and that shares of stock are not "denominated" in any one currency. However, he noted that, just as in the first scenario, he did not think the functional currency was relevant.

24. Mr. Trott stated that he agreed with Mr. Young because stock is not a monetary item. He stated that stock is a financial instrument and that saying stock was denominated in any currency was like saying land was denominated in a currency. Mr. Trott stated that he agreed with the staff recommendation.

25. Mr. Herz stated that he agreed with the staff's recommendation on this scenario. He stated that since this scenario was involved in several recent restatements that resulted in bifurcation, it would be important to make the views of the FASB known on this issue.

26. Mr. Linsmeier stated that this exposure draft would provide a good opportunity to clarify what “denominated in a foreign currency” means.

27. All seven Board members agreed that the embedded conversion option in the second scenario was issued solely to the issuer’s own stock and that it would meet the scope exception in paragraph 11(a) of Statement 133.

Transition

30. Mr. Beckendorff stated that, upon adoption of this guidance, if an entity determines that an embedded conversion option is required to be separately accounted for as a derivative instrument, as in Scenario 1 of this Issue, the embedded conversion option shall be measured at its fair value at the date of adoption and the debt host contract shall be measured at the accreted value that would have been recorded at that date if the embedded conversion option had been bifurcated at issuance. He stated that the difference between (a) the new aggregate carrying amount of the embedded conversion option and the accreted debt host immediately after adoption and (b) the old carrying amount of the convertible debt instrument immediately prior to adoption shall be recognized as a cumulative effect adjustment to the opening balance of retained earnings.

31. Mr. Beckendorff stated that, if an embedded conversion option has been separately accounted for as a derivative instrument, but in fact does qualify for the scope exception in paragraph 11(a) of Statement 133 (as in Scenario 2 of this Issue) upon adoption of the guidance, the carrying amount of the liability for the conversion option (that is, its fair value) shall be reclassified to equity. He stated that any debt discount that had been recognized when the conversion option was originally bifurcated from the convertible debt instrument should continue to be amortized.

32. Mr. Beckendorff stated that the staff recommends implementation guidance for this Issue be effective for financial statements issued for interim and

annual periods beginning after the date that the Board-cleared guidance is posted on the FASB website.

33. Mr. Stevens stated that this transition was consistent with outside input that he collected after the education session on this issue. He stated that Statement 133 did not lend itself to bifurcating embedded conversion options after issuance because, if stock prices go far in the money, one could end up with a de-minimus value for the debt host which would, in turn, generate an interest expense that would not reflect the economics of the situation. He stated that, while this transition requires two fair value measurements, one at the date of original issuance and one at the adoption date, the staff believes it prevents situations where interest costs will not be economically representative.

34. Mr. Stevens stated that for the second scenario transition, the staff looked mostly to the EITF Issue No. 06-7, "Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133," which acknowledges that APB 14 has its shortcomings and that if an instrument is currently being separated, such that a more economic interest cost is being reflected, it is not necessary to re-combine it and reverse all of the prior expenses.

35. All Board members agreed with the transition guidance for both scenarios, however, there were issues regarding the timing of the affect.

36. Mr. Linsmeier stated that he was under the impression that the Board's were moving to implementation only at the beginning of annual periods. Mr. Trott noted that allowing early interim adoption might prevent companies from having to restate now, and restate again later once the FASB requires adoption.

37. Ms. Seidman stated that allowing adoption anytime other than the beginning of the year would create earnings per share problems.

38. The Board agreed to require implementation as of the beginning of the year following the date that the Board-cleared guidance is posted to the website.

Follow-Up Items:

The staff plans to draft an Implementation Issue to be posted to the FASB website and exposed for a comment period of 35 days.

General Announcements:

None.