FASB Emerging Issues Task Force

Issue No. 05-1

Title: Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option

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References:

FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FAS 15)

FASB Statement No. 84, *Induced Conversions of Convertible Debt* (FAS 84)

FASB Statement No. 128, *Earnings per Share* (FAS 128)

FASB Technical Bulletin No. 80-1, *Early Extinguishment of Debt through Exchange for Common or Preferred Stock* (TB 80-1)

FASB proposed revised Statement No. 128, *Earnings per Share* (proposed FAS 128(R))

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

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* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

APB Opinion No. 26, *Early Extinguishment of Debt* (APB 26)

AICPA Accounting Interpretation No. 1, *Debt Tendered to Exercise Warrants*, of APB Opinion No. 26 (AIN-APB 26)

EITF Issue No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion" (Issue 90-19)

EITF Issue No. 02-15, "Determining Whether Certain Conversions of Convertible Debt to Equity Securities Are within the Scope of FASB Statement No. 84" (Issue 02-15)

EITF Issue No. 03-7, "Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)" (Issue 03-7)

EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share" (Issue 04-8)

EITF Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in EITF Issue No. 00-19, 'Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock'" (Issue 05-2)

EITF Abstracts, Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share" (Topic D-72)

Background

1. At the September 29–30, 2004 EITF meeting, a consensus was reached on Issue 04-8. Subsequently, the question was raised as to whether the contingently convertible instruments (CoCos) addressed in Issue 04-8 also may contain an embedded call option that permits conversion of an instrument even when the instrument's market price trigger has not been met. Although this Issue was raised in the context of CoCos with market price triggers, it also extends beyond market price triggers to any situation in which a call option permits conversion of an instrument that is not otherwise convertible. These call options provide the issuer with the ability to call the debt at any time (excluding lock-out periods). The holder has the flexibility to receive cash for the call price or equity. The holder typically will choose to receive equity if the conversion ratio is at a premium to the call price of the debt. Therefore, if the issuer prefers to settle the debt in shares, it may call the debt anytime before maturity (including days before maturity), and if the conversion ratio is at a premium to the call amount of the debt, the instrument holder would be expected to convert the debt to equity.

2. To illustrate the underlying issue, consider the following two examples.

Example 1

An entity issues a debt instrument with a $1,000 par amount and a maturity date of December 31, 2010. The issuer can call the debt anytime between 2005 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the par amount of the debt or a fixed number of shares. If the issuer does not call the debt, the holder does not have a conversion option and will receive cash at maturity.

Example 2

An entity issues a contingently convertible debt instrument with a market price trigger, a $1,000 par amount, and a maturity date of December 31, 2020. The debt instrument is convertible at the option of the holder if the share price of the issuer exceeds a specified amount. The issuer can call the debt anytime between 2009 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the call amount or a fixed number of shares, regardless of whether the market price trigger has been met.

3. At the March 17, 2005 EITF meeting, the Task Force reached a tentative conclusion that no gain or loss should be recognized upon conversion of an instrument that becomes convertible as a result of an issuer's exercise of a call option pursuant to the original terms of the instrument (View A, in the minutes). The Task Force based its tentative conclusion on the fact that APB 26 does not apply to debt that is converted to equity of the issuer based on conversion privileges that were included in the terms of the instrument. However, there were some Task Force members and some Board members who expressed a preference for another view (View C, in the minutes), and certain Board members stated that they would object to the ratification of a consensus based on the current tentative conclusion.

4. Also at the March meeting, the Task Force directed the FASB staff to consider the earnings per share treatment for these instruments before the exercise of the call option and then compare that treatment to the earnings per share treatment for instruments with similar terms.

5. At the June 15–16, 2005 EITF meeting the Task Force considered four examples that provided a context in which to demonstrate the earnings per share treatment for certain types of debt instruments under the tentative conclusion. It should be noted that the earnings per share treatment is the same regardless of the consensus reached by the Task Force in this Issue because the earnings per share treatment is applied prior to the instrument(s) being converted. The earnings per share treatment was provided to assist Task Force members in their evaluation of the propriety of View A, not to provide earnings per share computational guidance. The examples also illustrate the application of APB 26.

6. At the June meeting, the Task Force also discussed the previously reached tentative conclusion, but was not asked to reach a consensus. Certain Task Force members proposed alternatives that would result in either debt conversion or extinguishment accounting depending on whether the shares underlying the conversion were included in diluted earnings per share before the issuer exercised its call. Other Task Force members proposed alternatives based on whether the instruments could be converted due to factors that were not within the control of the issuer. The Task Force asked the FASB staff to research these alternatives for consideration by the Task Force at the September 15, 2005 EITF meeting.

7. Based on the discussion at the June meeting, the staff has carried forward the view representing the previous tentative conclusion and developed additional views for the Task Force's consideration. The examples considered at the June meeting have been carried forward and one additional example has been provided.

8. For reference, APB 26 applies to all extinguishments of debt except debt that is extinguished through a troubled debt restructuring and "debt that is converted to equity securities of the debtor pursuant to conversion privileges provided in terms of the debt at issuance." For extinguishments within its scope, APB 26 requires that a difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized in income.

Scope

9. This issue applies to the issuance of equity securities in settlement of a debt instrument that only became convertible upon the issuer's exercise of a call option.

Accounting Issue and Alternatives

How the conversion of an instrument that becomes convertible upon the issuer's exercise of a call option should be accounted for.

View A: The issuance of equity securities to settle the instrument should be accounted for as a conversion. No gain or loss should be recognized.

10. Proponents of View A believe that the form of settlement (that is, cash or equity securities) of the instrument is always at the discretion of the holder in accordance with a conversion right that is embedded in the original instrument. They believe that the varying degrees to which a holder may exercise its conversion right effects the pricing of an instrument but does not change the fundamental character of the conversion option, which always serves to improve the pricing of the instrument from the perspective of the issuer and reduce the risk to the holder by providing alternative settlement options. That is, whether the holder has the right to convert the instrument (a) unilaterally in accordance with a noncontingently convertible instrument, (b) upon the satisfaction of a market or substantive non-market-based contingency or combination of such contingencies, or (c) only upon the exercise of an issuer's call option effects the relative premium

an investor is willing to pay for an instrument but does not change the fundamental character of the conversion option. Accordingly, proponents of View A believe that the issuance of equity shares in settlement of an instrument should not give rise to a gain or loss.

11. Opponents of View A note that View A allows the possibility that an instrument may be excluded from diluted earnings per share (DEPS) throughout its life, yet still receive preferential conversion accounting upon settlement, as illustrated in Examples 4 and 5. Of particular concern to those opponents is the possibility that, based on a View A consensus, issuers may add call features to existing or new agreements that, upon exercise, provide the holder the right to convert the instrument to a variable number of equity shares where the number of shares would correlate to a predetermined premium relative to the par value of the debt. Upon conversion, based on View A, the issuer would avoid extinguishment accounting even though the instrument is economically similar to a traditional debt instrument that is callable at a predetermined premium relative to par.

View B: Issuance of equity securities to settle an instrument that only can become convertible upon the occurrence of an event that is within the control of the issuer should be recognized as a debt extinguishment. In contrast, issuance of equity securities to settle an instrument that may become convertible upon the occurrence of a substantive contingency outside the control of the issuer should be recognized as a conversion.

12. Proponents of View B generally agree with proponents of View A that a conversion of an instrument in accordance with a conversion right included in that instrument's original terms should not give rise to gain or loss. However, they believe that when an instrument can only become convertible based on an event that is within the control of the issuer, the conversion right serves as a settlement alternative from the perspective of the holder rather than a conversion privilege. As such, they believe the issuance of equity securities to settle those instruments should be recognized as the extinguishment of a debt instrument in accordance with APB 26.

13. Proponents of View B also believe that accounting for the issuance of equity securities to settle a contingently convertible debt instrument as a conversion rather than an extinguishment is consistent with the conclusions in Issue 05-2. In Issue 05-2, the Task Force reached a consensus that "instruments that provide the holder with an option to convert into a fixed number of shares

(or equivalent amount of cash at the discretion of the issuer) for which the ability to exercise the option is based on the passage of time or a contingent event should be considered 'conventional' for purposes of applying Issue 00-19." Based on that conclusion, proponents of View B believe that a contingently convertible debt instrument should also be considered 'conventional' upon its conversion.

14. Some opponents, however, note that Issue 05-2 provides guidance about when a conversion feature might require bifurcation and recognition as a derivative. They believe the conversion feature is the relevant characteristic of the instruments addressed by Issue 05-2, while it is the call feature that distinguishes instruments within the scope of this Issue. Based on that view, they are not troubled by reaching different conclusions in this Issue compared with Issue 05-2 on what they view as substantially different instruments.

15. Other opponents believe that, similar to View A, View B allows the possibility that an instrument may be excluded from DEPS throughout its life yet still receive preferential conversion accounting upon settlement. They acknowledge that the potential population of those instruments is smaller than under View A but believe it is still significant.

View C: The issuance of equity securities to settle an instrument that is within the scope of Issue 04-8 should be treated as a conversion. The issuance of equity securities to settle an instrument that is not within the scope of Issue 04-8 should be recognized as a debt extinguishment.

16. Proponents of View C believe that the issuance of equity securities to settle conventional convertible debt should be accounted for as a conversion, while the issuance of equity securities to settle nonconventional convertible debt should be accounted for as an extinguishment. They believe that the Task Force effectively defined conventional convertible debt for purposes of DEPS through its conclusion in Issue 04-8. The conclusion in Issue 04-8 is based on the notion that a contingently convertible instrument with a market price trigger is substantially equivalent to a conventional convertible instrument with a market price conversion premium. Similarly, proponents of View C believe that the conversion feature in a CoCo subject to a market price trigger is equivalent to the conversion feature that exists in a conventional convertible debt instrument and, therefore, such instruments are not within the scope of APB 26. Accordingly,

proponents of View C believe that the issuance of equity securities to settle instruments within the scope of Issue 04-8 should be accounted for as a conversion.

17. Other proponents note that View C generally provides consistency between the DEPS treatment and accounting for the conversion of an instrument. That is, no instrument excluded from DEPS would qualify for conversion accounting.

18. Some opponents note that it is possible that a CoCo subject to a market price trigger may be "in-the-money" from the perspective of the holder yet may not be currently convertible because the market price trigger has not been achieved. They believe a holder receives incremental value in this situation, similar to the incremental value received by the holder of an instrument that is convertible upon satisfaction of a non-market-based contingency and that the incremental value should be recognized similarly for each instrument, as an extinguishment.

View D: The issuance of equity securities to settle the instrument should be recognized as a debt extinguishment.

19. Proponents of View D believe that a conversion feature that allows a holder to convert the instrument only upon the occurrence of some event that is within the control of the issuer (for example, exercise of a call option) is a settlement alternative rather than a conversion privilege included in the original terms of the instrument. Based on that conclusion, they believe that such instruments do not qualify for the scope exception in APB 26 and that the issuance of equity shares to settle the debt should be recognized as an extinguishment.

20. Proponents of View D note that the holder receives incremental value upon the issuer's decision to extinguish the debt by exercise of the call option. They believe exercise of the call represents an offer to extinguish the instrument at the date the call is exercised and that the incremental value the holder receives should be reflected as an extinguishment.

21. Consistent with Views A and B, some opponents to View D note that the terms of the conversion feature (for example, the number of shares to which the holder would be entitled) are established upon issuance of the instrument and are reflected in the original terms of the instrument. They believe that, like any conversion feature, the probability that it will become operational (that is, that the holder will have an opportunity to elect to receive equity shares in

settlement of the instrument) is reflected in the negotiated fair value of the instrument upon issuance. Accordingly, they believe that an issuer's exercise of a call option triggers a conversion feature that was included in the original terms of the instrument and that the issuance of equity securities to settle the instrument should be accounted for as a conversion.

22. Some opponents of View D note the inconsistent accounting results that can arise for a single instrument depending on how the instrument is ultimately converted, though the conversion is always at the discretion of the issuer. Proponents of View D believe that the fact the exercise of a call option leads to a different accounting result than conversion pursuant to the original terms of the instrument is justified because the call and conversion represent different economic phenomena.

23. Other opponents of View D believe it is inconsistent with the conclusions reached by the Task Force in both Issues 04-8 and 05-2. Proponents of View D, however, note that Issues 04-8 and 05-2 address earnings per share and accounting for the issuance of an instrument, respectively. As such, they do not believe the conclusions are necessarily relevant to accounting for the conversion of an instrument.

24. The Task Force will be asked to reach a consensus on the issue of how the conversion of an instrument that becomes convertible upon the issuer's exercise of a call option should be accounted for based on the additional information that is provided in this Issue Summary.

Example 1—Convertible Debt Security

An entity issues a convertible bond for par in the amount of $1,000 and a maturity date of December 31, 2025. The issuer can call the bond for its par amount at any time after December 31, 2008, and the holder may put back the bond to the issuer for its par value on the following dates: January 1, 2010, and January 1, 2020. At the bond's issuance date, the issuer's stock price is $70 and the holder can convert the bond into 10 shares at any time. If the issuer calls the debt, the holder has the option of receiving cash for the par amount or 10 shares.

On January 1, 2009, the issuer calls the bond when its stock price is $110. The holder has the option of receiving cash for the par amount ($1,000) or 10 shares of stock with a market value of $1,110. The holder elects to convert the bond and receive 10 shares of stock.

Scope

The issuer's exercise of the call option resulted in the holder converting the bond into shares on January 1, 2009. However, because in this fact pattern the holder has the ability to convert the bond into 10 shares at any time, the conversion does not fall within the scope of Issue 05-1. The conversion of the bond occurred pursuant to its original terms and the carrying amount of the debt is credited to equity and no gain or loss is recognized.

Earnings per share impact

In accordance with the convertible securities provisions of FAS 128, the dilutive effect of the bond would be reflected in diluted earnings per share using the if-converted method as of the bond's issuance date.

Example 2—Contingently Convertible Debt

An entity issues a CoCo for par in the amount of $1,000 and a maturity date of December 31, 2025. The issuer can call the bond for its par amount at any time after December 31, 2008, and the holder may put back the bond to the issuer for its par value on the following dates: January 1, 2010, and January 1, 2020. At the bond's issuance date, the issuer's stock price is $70 and the holder can convert the bond into 10 shares of common stock upon the occurrence of any one of the following three events:

1. If the issuer calls the CoCo, the holder has the option to receive cash for the par amount of the instrument or exercise its conversion option and receive 10 shares of common stock.
2. If the market price of the issuer's stock exceeds $120 for a consecutive 30-day period (market price trigger), the CoCo becomes convertible at the holder's option during the subsequent calendar quarter.

3. Upon the consummation of a change in control of the issuer, the holder of the CoCo can exercise its conversion option.

Example 2—Scenario #1

The issuer's stock price exceeds $120 for 30 consecutive trading days from May 1 to May 30, 2009, which pursuant to the original terms of the CoCo provides the holder with the option to convert anytime from July 1 through September 30, 2009. On September 30, 2009, the issuer's share price is $110 and the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100.

Scope

The holder converted the CoCo pursuant to its original terms so the conversion is not within the scope of Issue 05-1. The carrying amount of the debt is credited to equity, and no gain or loss is recognized.

Earnings per share impact

In accordance with the provisions of Issue 04-8, the dilutive effect of the CoCo would be reflected in diluted earnings per share using the if-converted method as of the bond's issuance date.

Example 2—Scenario #2

The issuer's stock price exceeds $120 for 29 consecutive trading days from May 1 to May 29, 2009, and on May 29, 2009, the issuer calls the CoCo when the stock price is $150 per share. The holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,500.

Scope

When the issuer exercised its call option on May 29, 2009, the holder did not have the legal right to convert based on the CoCo's market price trigger contingency provision because the market price trigger was only satisfied for 29 days and, therefore, falls 1 day short of the 30-day requirement stipulated in the original terms of the CoCo. This scenario is within the scope of Issue 05-1 because the issuer provides the holder with the opportunity to convert, which it did not have otherwise.

Analysis of fact pattern under View A

The issuance of equity shares to settle the CoCo is considered to have occurred pursuant to its original terms. Therefore, the carrying value of the CoCo is credited to equity, and no gain or loss is recognized.

Analysis of fact pattern under View B

The original terms of the CoCo provided that it could become convertible upon the occurrence of substantive contingencies outside the control of the issuer. Accordingly, the instrument is considered conventional convertible debt per the conclusions reached in Issue 05-2, and the issuance of equity shares to settle the instrument should be recognized in the same manner as the conversion of conventional convertible debt. Therefore, the carrying value of the CoCo is credited to equity, and no gain or loss is recognized.

Analysis of fact pattern under View C

As described in the analysis of earnings per share impact below, the instrument is within the scope of Issue 04-8 because it is convertible based on achievement of a market price trigger. There is no substantive economic difference between an instrument contingently convertible based upon achievement of a market price trigger and a conventional convertible instrument with a market price conversion premium. Accordingly, the instrument should be treated as a conventional convertible instrument, and the issuance of equity shares to settle the instrument should be recognized as a conversion. The carrying value of the CoCo is credited to equity, and no gain or loss is recognized.

Analysis of fact pattern under View D

Under View D, the conversion of the CoCo is not considered to have occurred pursuant to its original terms. Therefore, the fair value of the stock issued ($1,500) is credited to equity, and the difference ($500) between the carrying value of the CoCo and the fair value of the stock issued is recorded as a loss.

Earnings per share impact

In accordance with the provisions of Issue 04-8 and the convertible securities provisions of FAS 128, the dilutive effect of the CoCo would be reflected in diluted earnings per share using the if-converted method as of the bond's issuance date.

Example 3—Instrument C in Issue 90-19 with a Market Price Trigger

In Example 3, the staff addresses Instrument C in Issue 90-19, but with an added feature of a market price trigger. Instrument C, as described in Issue 90-19, is a debt instrument, and when it is converted, the issuer must satisfy the accreted value of the obligation in cash and may satisfy the conversion spread in either cash or stock.

An entity issues a contingently convertible bond for par in the amount of $1,000 and a maturity date of December 31, 2025. The issuer can call the bond for its par amount at any time after December 31, 2008, and the holder may put back the bond to the issuer for its par value on the following dates: January 1, 2010, and January 1, 2020. At the bond's issuance date, the issuer's stock price is $70, and the conversion ratio of the bond is equivalent to 10 shares of the issuer's stock. Upon conversion, at the issuer's option, the issuer must satisfy the accreted value of the bond in cash and may satisfy the conversion spread in either cash or stock. Assume that deferred financing costs of $50 remain unamortized at the conversion date.

The bond may be exercised at the holder's option following the occurrence of either of the following events:

1. If the market price of the issuer's stock exceeds $120 for a consecutive 30-day period (market price trigger), the bond becomes convertible at the holder's option during the subsequent calendar quarter.
2. Upon the consummation of a change in control of the issuer, the holder of the bond can exercise its conversion option.

Example 3—Scenario #1

The issuer's stock price exceeds $120 for 30 consecutive trading days from May 1 to May 30, 2009, which pursuant to the original terms of the bond provides the holder with the option to convert at any time from July 1 through September 30, 2009. On September 30, 2009, the issuer's share price is $110, and the holder elects to convert the bond and receives $1,000 and 0.909 shares of common stock valued at $100.

Scope

The holder converted the CoCo pursuant to its original terms so the conversion is not within the scope of Issue 05-1. Issue 03-7 addresses how an issuer should account for the partial cash-based and partial stock-based settlement of a debt instrument structured in the form of Instrument C. Only the cash payment is considered in the computation of the gain or loss on extinguishment of the bond, and the share(s) transferred to settle the excess conversion spread is not considered in the settlement of the bond.

The 0.909 shares exchanged to settle the conversion spread is not considered a component of the extinguishment gain or loss calculation, and because the bond was issued at par, the loss on the extinguishment is $50, which is attributable to the unamortized deferred financing costs.

Earnings per share impact

The bond contains a market price trigger and, in accordance with the provisions of Issue 04-8, should be reflected in dilutive earnings per share from the date of issuance. The bond would be reflected in diluted earnings per share computed in accordance with Issue 90-19. There would be no adjustment to the numerator in the earnings per share computation for the cash-settled portion of the bond because that portion of the bond is always settled in cash. The conversion spread should be assumed to be settled in shares and reflected in diluted earnings per share.

Example 3—Scenario #2

The issuer's stock price exceeds $120 for 30 consecutive trading days from May 1 to May 30, 2009, and, therefore, the bond's holder can convert the bond at its discretion during the period from July 1, 2009 through September 30, 2009. The holder elects not to exercise his conversion rights during that period. On October 2, 2009, the issuer calls the bond when its share price is $110. The holder converts the bond and receives $1,000 and 0.909 shares valued at $100.

Scope

When the issuer exercised its call option on October 2, 2009, the holder did not have the right to convert based on the original terms of the bond. Therefore, this scenario is within the scope of Issue 05-1 because the issuer provides the holder with the opportunity to convert, which it would not have had otherwise. However, it is also within the scope of Issue 03-7 because the par amount of the bond is to be settled in cash and the conversion spread is to be settled in stock.

Analysis of fact pattern under View A

Because the conversion occurred pursuant to the bond's original terms, it is within the scope of Issue 05-1, but the gain or loss on conversion should be computed based on the guidance in Issue 03-7.

Analysis of fact pattern under View B

The original terms of the instrument provided that it could become convertible upon the occurrence of substantive contingencies outside the control of the issuer. Accordingly, the instrument is considered conventional convertible debt per the conclusions reached in Issue 05-2, and the issuance of equity shares to settle the instrument should be recognized in the same manner as the conversion of conventional convertible debt. Therefore, the gain or loss on conversion should be computed based on the guidance in Issue 03-7.

Analysis of fact pattern under View C

As described in the analysis of earnings per share impact below, the instrument is within the scope of Issue 04-8 because it is convertible based on achievement of a market price trigger. There is no substantive economic difference between an instrument contingently convertible based on achievement of a market price trigger and a conventional convertible instrument with a market price conversion premium. Accordingly, the issuance of equity shares to settle the instrument should be recognized in the same manner as the conversion of conventional convertible debt. Therefore, the gain or loss on conversion should be computed based on the guidance in Issue 03-7.

Analysis of fact pattern under View D

Under View D, the conversion of the bond is not considered to have occurred pursuant to its original terms. Therefore, the loss on extinguishment of the bond is $150; comprising $100, which represents the difference between the settlement value of $1,100 and the carrying value of the bond, and the remaining unamortized deferred financing costs of $50.

Interaction of this Issue with Issue 03-7

As noted above, some believe the example instrument presented is within the scope of both Issue 05-1, as currently defined, and Issue 03-7. Depending on the nature of contingencies associated with an instrument with the characteristics of Instrument C, View C might require extinguishment accounting for the issuance of equity securities to settle the conversion spread, similar to View D above. Extinguishment accounting related to the issuance of equity shares is not consistent with the guidance provided in Issue 03-7, as described below. If the Task Force were to reach a consensus consistent with View C or D, the FASB staff believes it would be necessary to clarify the interaction of Issue 05-1 and Issue 03-7. In such circumstance, the FASB staff believes the Task Force should clarify that if the issuance of equity securities qualifies for conversion accounting pursuant to Issue 05-1, the settlement of the instrument should be recognized in accordance with the guidance in Issue 03-7, otherwise the settlement should be recognized in accordance with the provisions of Issue 05-1.

Treatment under Issue 03-7

The cash payment of $1,000 and the unamortized deferred financing costs are considered in the computation of the gain or loss on extinguishment of the bond, and the 0.909 shares transferred to settle the excess conversion spread is excluded pursuant to the guidance in Issue 03-7. Therefore, the loss on extinguishment is $50 because the bond was issued at par of $1,000. The $50 is attributable to the unamortized deferred financing costs.

Earnings per share impact

The bond contains a market price trigger and, in accordance with the provisions of Issue 04-8, should be reflected in dilutive earnings per share from the date of issuance. The bond would be reflected in diluted earnings per share computed in accordance with Issue 90-19. There would be no adjustment to the numerator in the earnings per share computation for the cash-settled portion of the bond because that portion of the bond is always settled in cash. The conversion spread should be assumed to be settled in shares and reflected in diluted earnings per share, if dilutive.

Example 4—Debt Contingently Convertible Based Only on a Change of Control

An entity issues a CoCo for par in the amount of $1,000 and a maturity date of December 31, 2025. The issuer can call the bond for its par amount at any time after December 31, 2008, and the holder may put back the bond to the issuer for its par value on the following dates: January 1, 2010, and January 1, 2020. At the bond's issuance date, the issuer's stock price is $70, and the holder can convert the bond into 10 shares of common stock upon the occurrence of any one of the following 2 events:

1. If the issuer calls the CoCo, the holder has the option to receive cash for the par amount of the instrument or exercise its conversion option and receive 10 shares of common stock.
2. Upon the consummation of a change in control of the issuer, the holder of the CoCo can exercise its conversion option.

Example 4—Scenario # 1

On January 1, 2009, the issuer announces that it is selling 100 percent of its outstanding shares for $110 per share and that the transaction will be consummated on February 1, 2009. The issuer's stock price increases to $110 in contemplation of the transaction. On February 1, 2009, the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100. Those shares are tendered to the acquiring company in exchange for $1,100.

Scope

The holder converted the CoCo pursuant to its original terms so the conversion is not within the scope of Issue 05-1. The carrying value of the debt is credited to equity, and no gain or loss is recognized.

Earnings per share impact

It is the FASB staff's understanding that, in practice, a CoCo that is convertible only upon satisfaction of a non-market-based contingency is evaluated under the contingently issuable share guidance in FAS 128. As such, it is not considered to represent potential common shares until such time as the contingency has been met.

Example 4 - Scenario # 2

On January 1, 2009, the issuer announces that it is selling 100 percent of its outstanding shares for $110 per share and that the transaction will be consummated on February 1, 2009. The issuer's stock price increases to $110 in contemplation of the transaction. On January 29, 2009, the issuer calls the CoCo when its stock price is $110. On January 29, 2009, the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100.

Scope

When the issuer exercised its call option on January 29, 2009, the holder did not have the ability to convert based on the change of control contingency. This scenario is within the scope of Issue 05-1 because the issuer provides the holder with the opportunity to convert, which it did not have otherwise.

Analysis of fact pattern under View A

The issuance of equity shares to settle the CoCo is considered to have occurred pursuant to its original terms. Therefore, the carrying value of the CoCo is credited to equity, and no gain or loss is recognized.

Analysis of fact pattern under View B

The original terms of the CoCo provided that it could become convertible upon the occurrence of substantive contingencies outside the control of the issuer. Accordingly, the instrument is considered conventional convertible debt per the conclusions reached in Issue 05-2, and the issuance of equity shares to settle the instrument should be recognized in the same manner as the conversion of conventional convertible debt. Therefore, the carrying value of the CoCo is credited to equity, and no gain or loss is recognized.

Analysis of fact pattern under View C

The instrument is not within the scope of Issue 04-8. Accordingly, issuance of equity securities to settle the instrument would be recognized as an extinguishment. Therefore, the fair value of the stock issued ($1,100) is credited to equity, and the difference ($100) between the carrying value of the CoCo ($1,000) and the fair value of the stock issued is recorded as a loss.

Analysis of fact pattern under View D

Under View D, the conversion of the CoCo is not considered to have occurred pursuant to its original terms. Therefore, the fair value of the stock issued ($1,100) is credited to equity, and the difference ($100) between the carrying value of the CoCo ($1,000) and the fair value of the stock issued is recorded as a loss.

Earnings per share impact

It is the FASB staff's understanding that, in practice, a CoCo that is convertible only upon satisfaction of a non-market-based contingency is evaluated under the contingently issuable share guidance in FAS 128. As such, it is not considered to represent potential common shares until such time as the contingency has been met.

Example 5—Issue 05-1's Original Example 1 (see paragraph 2, above)

On January 1, 2005, an entity issues a debt instrument with a $1,000 par amount and a maturity date of December 31, 2010. The issuer can call the debt anytime between 2005 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the par amount of the debt or 10 shares of common stock. If the issuer does not call the debt, the holder does not have a conversion option and will receive cash in the amount of $1,000 (par value) at maturity. Assume on the date that the issuer calls the debt that the unamortized deferred financing costs are $50.

Example 5 – Scenario #1

The issuer calls the debt on September 30, 2006, when its stock is trading at $95 per share. The holder elects to receive cash for the par amount of the bond ($1,000) because the 10 shares have a market value of only $950.

Scope

The issuer has the right to call the debt at any time pursuant to the original terms of the bond, and because the issuer called the debt before its maturity date, the holder has the right per the terms of the bond to choose cash or shares. In this scenario it is probable that the holder would choose cash settlement as it is economically the most attractive to the holder. Assuming the holder elects to receive cash in settlement of the debt, this scenario is not within the scope of Issue 05-1 because equity securities are not issued in settlement of the instrument.

The repayment of the bond in cash for par of $1,000 is accounted for as an extinguishment of debt under APB 26, and the loss on extinguishment of $50 is due to the write-off of the unamortized deferred financing costs.

Example 5—Scenario #2

The issuer calls the debt on December 30, 2006, when its stock is trading at $110 per share. The holder elects to convert the bond into 10 shares valued at $1,100 rather than receive cash for the par amount of the bond ($1,000).

Scope

The issuer has the right to call the debt at any time pursuant to the original terms of the bond, and because the issuer called the debt before its maturity date, the holder has the right per the terms of the bond to choose cash or shares. Because the holder did not have the ability to convert the debt prior to the issuer calling it, the conversion is within the scope of Issue 05-1.

Analysis of fact pattern under View A

Conversion of the bond is considered to have occurred pursuant to the bond's original terms. Therefore, the carrying amount of the bond is credited to equity, the related unamortized deferred financing is debited to equity, and no gain or loss is recognized.

Analysis of fact pattern under View B

The original terms of the CoCo do not provide that it could become convertible except upon the occurrence of an event that is within the control of the issuer. Because the instrument may only become convertible based on the occurrence of an event that is within the control of the issuer, the conversion right serves only as a settlement alternative from the perspective of the holder. Accordingly, the conversion right is not deemed to exist in the original terms of the instrument, and the issuance of equity shares to settle the instrument should be recognized as an extinguishment under APB 26. Therefore, the fair value of the stock ($1,100) is credited to equity, and the difference ($100) between the bond's carrying value ($1,000) and the fair value of the stock issued is recorded as a loss. The unamortized deferred financing costs of $50 also would be written off resulting in a total loss of $150.

If the instrument would not be deemed to represent potential common shares, in accordance with FAS 128, immediately prior to the issuer’s exercise of the call, the issuance of equity securities to settle the instrument would be accounted for as an extinguishment. Therefore, the fair value of the stock ($1,100) would be credited to equity, and the difference ($100) between the bond's carrying value ($1,000) and the fair value of the stock issued is recorded as a loss. The unamortized deferred financing costs of $50 also would be written off, resulting in a total loss of $150.

Analysis of fact pattern under View C

The instrument is not within the scope of Issue 04-8. Accordingly, issuance of equity securities to settle the instrument would be recognized as an extinguishment. Therefore, the fair value of the stock ($1,100) would be credited to equity, and the difference ($100) between the bond's carrying value ($1,000) and the fair value of the stock issued is recorded as a loss. The unamortized deferred financing costs of $50 also would be written off, resulting in a total loss of $150.

Analysis of fact pattern under View D

Under View D, the conversion of the bond is not considered to have occurred pursuant to its original terms. Therefore, the fair value of the stock ($1,100) is credited to equity, and the difference ($100) between the bond's carrying value ($1,000) and the fair value of the stock issued is recorded as a loss. The unamortized deferred financing costs of $50 also would be written off, resulting in a total loss of $150.

Earnings per share impact

Some believe that this instrument falls under the guidance in paragraph 29 of FAS 128 because it may be settled in cash or shares. However, others believe that this instrument falls under the contingently issuable shares guidance in FAS 128 because the holder cannot exercise the settlement option until the issuer exercises its call option.

Under paragraph 29 it is presumed that the instrument will be stock settled and the resulting potential common shares will be included in diluted earnings per share, if dilutive. However, the issuer can overcome the presumption of share settlement if it has a stated policy or past experience that provides a reasonable basis that the instrument will be settled in cash. The determination of whether the instrument is to be reflected in DEPS is made each period based on the facts available.

If the issuer has the ability to overcome the presumption of share settlement, then upon exercise of the call option, the issuer no longer has control over how the instrument is settled, and Topic D 72 applies. Topic D 72 provides that when the counterparty controls the means of settlement, the more dilutive of cash settlement or share settlement is used. Therefore, the issuer must assess the holder's settlement alternatives and use the most dilutive to EPS.

For example, if the issuer has a stated policy that it will not call the debt when the conversion option is in-the-money, the settlement method (cash) remains in control of the issuer. Accordingly, the shares underlying the conversion are excluded from the issuer's diluted earnings per share computation. However, if the issuer exercises its call option when its shares are in-the-money, the holder has the choice of settlement options (cash or shares) and will choose share settlement because it is economically the more attractive of the two settlement alternatives. Accordingly, the issuer should include the shares underlying the in-the-money conversion option when it exercises its call.

Under the contingently issuable share guidance, the shares would not be included in DEPS until the issuer called the debt and share settlement was economically the more attractive of the two settlement alternatives to the holder.

Earnings per share impact under proposed FAS 128(R)

25. Proposed FAS 128(R) has not been finalized, and further Board deliberations are expected. Proposed FAS 128(R) is also expected to be reexposed for public comment, and any decisions reached on the Exposure Draft are subject to change based on the Board's deliberations on the comments received. Accordingly, the staff did not include an analysis of the provisions of proposed FAS 128(R) for any of the instruments addressed herein.

Transition

26. It is not expected that a consensus on this Issue will result in a significant change, if any, in practice because practitioners, as well as members of the EITF Agenda Committee, have informed the FASB staff that they have not seen such conversions in practice. However, both groups believe it may be an issue in 2005 that will need to be addressed because many of the CoCos that were issued in 2000 and 2001 have call options that become exercisable commencing in 2005.

27. The FASB staff's recommendation is that the transition guidance in this Issue shall be effective for periods beginning after Board ratification of the consensus and shall apply to all conversions of instruments that otherwise are not convertible or not currently convertible based on a contingency. Early application of this guidance is permitted in periods for which financial statements have not yet been issued. Restatement of previously issued financial statements is not permitted.