Staff Summary of GAAP for Convertible Instruments

1. Current GAAP for convertible instruments is included in Subtopic 470-20, Debt—Debt with Conversion and Other Options. There is a significant amount of legacy GAAP that was developed on a piecemeal basis and combined into this Subtopic. This section explains the key areas of GAAP for convertible debt and how each model was developed to provide an understanding of the complexity of the guidance encountered in practice.

Traditional Convertible Debt

2. The accounting for convertible debt was first addressed by standard setters in the 1960s. The first Standard issued on this topic was APB Opinion No. 10, *Omnibus Opinion—1966*. That Standard required separation of convertible debt using the liability-first approach to separate the liability and equity components of convertible debt. Paragraphs 8–9 of that Standard contained the following guidance:

> A portion of the proceeds received for bonds or other debt obligations which are convertible into stock, or which are issued with warrants to purchase stock, is ordinarily attributable to the conversion privilege or to the warrants, a factor that is usually reflected in the stated interest rate. In substance, the acquirer of the debt obligation receives a “call” on the stock. **Accordingly, the portion of the proceeds attributable to the conversion feature or the warrants should be accounted for as paid-in capital** (typically by a credit to capital surplus); however, as the liability under the debt obligation is not reduced by such attribution, the corresponding charge should be to debt discount. Upon conversion, the related unamortized debt discount should be accounted for as a reduction of the consideration for the securities being issued. [Emphasis added.]

> **The discount or reduced premium, in the case of convertible debt obligations, may ordinarily be measured as the difference between the price at which the debt was issued and the estimated price at which it would have been issued in the absence of the conversion feature.** Warrants are frequently traded and their fair value can usually be determined by market prices at the time the debt is issued; accordingly, proceeds of the issue can be allocated in proportion to the relative market values of the debt obligations and the warrants. [Emphasis added.]

3. However, this guidance in APB 10 was suspended one year after issuance and was then nullified by APB 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase*...
Warrants, issued in 1969. APB 14 changed the conclusion to no separation of convertible debt and was retroactively effective to the initial effective date of APB 10. APB 14 cites the inseparability of traditional convertible debt as the basis for the decision to account for a single liability as explained in the following excerpts:

7. The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. **Furthermore the two choices are mutually exclusive; they cannot both be consummated.** Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he forgoes the right to redemption, and vice versa. [Emphasis added.]

12. The Board is of the opinion that no portion of the proceeds from the issuance of the types of convertible debt securities described in paragraph 3 should be accounted for as attributable to the conversion feature. **In reaching this conclusion, the Board places greater weight on the inseparability of the debt and the conversion option (as described in paragraph 7) and less weight on the practical difficulties.** [Emphasis added.]

4. In 1969, the APB also issued APB Opinion No. 15, *Earnings per Share*, almost concurrent with the issuance of APB 14. That Standard adjusted the computation of fully diluted EPS, and required it to be presented in the income statement when common stock was contingently issuable and if primary earnings per share for the period would have been reduced had such contingent issuances taken place at the beginning of the period. The basis for this guidance seems to align with the guidance in APB 14 requiring no separation of traditional convertible debt. The Standard notes that,

The if-converted method recognizes the fact that the holders of convertible securities cannot share in distributions of earnings applicable to the common stock unless they relinquish their right to senior distributions…The if-converted method also recognizes the fact that a convertible issue can participate in earnings, through dividends or interest, either as a senior security or as a common stock, but not both.

5. Subtopic 470-20 contains the guidance originally included in APB 14. For convertible debt with the following two characteristics, the guidance requires that the debt be accounted for as a single liability with no recognition of the conversion option:
(a) The debt instrument is convertible into common stock of the issuer or an affiliated entity at a specified price at the option of the holder.
(b) The debt instrument is sold at a price or has a value at issuance not significantly in excess of the face amount.

6. The terms of convertible debt instruments addressed by that guidance generally include instruments that have an interest rate that is lower than the issuer could establish for nonconvertible debt, an initial conversion price that is greater than the fair value of the common stock at time of issuance, and a conversion price that does not decrease except pursuant to antidilution provisions. Typically, the debt is also callable at the option of the issuer and subordinated to nonconvertible debt.

7. APB 14 also required debt with detachable stock purchase warrants to be separated into two components. Proceeds from the sale of a debt instrument with detachable stock purchase warrants (call options) are required to be allocated based on the relative fair values of the debt instrument without the warrants and of the warrants themselves at the time of issuance. The portion of the proceeds allocated to the warrants are required to be accounted for as paid-in capital, and the remainder of the proceeds is allocated to the debt instrument portion of the transaction. This usually results in a discount that is to be accreted. If the warrants are nondetachable and the debt instrument must be surrendered to exercise the warrant, the two instruments taken together are substantially equivalent to a convertible debt instrument and no separation is required.

8. This separation guidance would also apply to a conversion option in a debt instrument that can be legally detached and separately exercised. An example of this is a convertible debt instrument that permits net share settlement of the conversion option such that the debt obligation remains outstanding and resets to a market rate for nonconvertible debt.

9. The guidance also requires that if a convertible debt instrument is issued at a substantial premium, a portion of the proceeds is allocated to paid-in capital. For example, this would apply if a convertible debt instrument is modified or exchanged in a manner that requires the application of extinguishment accounting and if the fair value of the modified instrument significantly exceeds its par value.
Convertible Debt with Issuer Option to Settle in Cash upon Conversion (EITF 90-19)

10. Convertible debt was next addressed in the 1990s with the issuance of EITF Issue No. 90-19, “Convertible Bonds with Issuer Option to Settle for Cash upon Conversion.” That guidance was issued to address the accounting for a debt instrument that is convertible into a fixed number of common shares where upon conversion, the issuer is either required or has the option to satisfy all or part of the obligation in cash. Common variations at the time this guidance was issued were the following:

a) Instrument A: Upon conversion, the issuer must satisfy the obligation entirely in cash based on the fixed number of shares multiplied by the stock price on the date of conversion.

b) Instrument B: Upon conversion, the issuer may satisfy the entire obligation in either stock or cash equivalent to the conversion value.

c) Instrument C: Upon conversion, the issuer must satisfy the accreted value of the obligation (the amount accrued to the benefit of the investor exclusive of the conversion spread) in cash and may satisfy the conversion spread (the excess of the conversion value over the accreted value) in either cash or stock.

11. The EITF reached a consensus that all three instruments should be accounted for on a combined basis. In addition, Instruments A and C were required to be accounted for similar to an indexed debt obligation, such that the carrying amount would be adjusted in each reporting period to reflect the current stock price, but not below the accreted value of the instrument. The EITF also concluded that Instruments B and C would use the if-converted method of computing diluted EPS, if the effect is dilutive. (Some of these conclusions were changed in 2002 following the issuance of FASB Statement No. 133,

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1 At that time, APB 15 was the Standard on computing EPS. Under that standard, convertible securities that required cash payments upon conversion were considered to be the equivalent of warrants. In that case, the if-converted method was required to be applied as if retirement or conversion of the securities had occurred and as if the excess proceeds had been applied to the purchase of common stock under the treasury stock method. In order to reflect maximum potential dilution, the market price at the close of the reporting period was used to determine the number of shares assumed to be repurchased (under the treasury stock method) only if it was higher than the average price used in computing primary EPS. The numerator was also adjusted to add back interest related to the conversion feature.
Accounting for Derivative Instruments and Hedging Activities, EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock,” and related guidance. Refer to paragraph 42 for those revised conclusions.)

Convertible Instruments with Beneficial Conversion Features (EITF 98-5 and 00-27)

12. The EITF next dealt with convertible debt instruments and convertible preferred securities with in-the-money embedded conversion options, referred to as BCFs. The guidance on BCFs in Topic 470-20 originated in EITF Issue No. 98-5, “Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios,” and EITF Issue No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments.” The guidance applies to both convertible debt and equity-classified convertible preferred stock that requires settlement in stock upon conversion. The guidance also applies to instruments with conversion features that are not beneficial at the commitment date but that become beneficial upon the occurrence of a future event, such as an initial public offering.

13. A BCF exists when the embedded conversion feature is in-the-money at the commitment date (that is, its conversion price is lower than the fair value of the issuer’s stock price). The commitment date is the date when the agreement meets the definition of a firm commitment (that is, the agreement specifies all significant terms and there is a sufficiently large disincentive for nonperformance such that performance is probable).

14. If a BCF exists, it must be measured at its intrinsic value and accounted for as equity. Intrinsic value is computed as the difference between the conversion price and the fair value of the issuer’s stock price at the commitment date multiplied by the number of shares into which the security is convertible. If the convertible debt has attached warrants that are separately convertible or exercisable, the conversion price for the purposes of the BCF accounting model will be different from the stated conversion price. This is because the sales proceeds are first allocated based on the relative fair value of the instruments before applying BCF accounting. The conversion price for BCF accounting purposes would then relate only to that portion of the proceeds allocated to the convertible instrument. The
accounting conversion price is determined by dividing the proceeds allocated to the convertible security by the number of shares into which it is convertible. The accounting conversion price is then compared to the fair value of the shares on the commitment date to arrive at the intrinsic value. The remainder of the proceeds is allocated to the liability component with a discount established as a result of recognizing the BCF. In any case, if the intrinsic value of the BCF is greater than the proceeds allocated to the convertible instrument, the amount of the discount assigned to the BCF is limited to the amount of the proceeds allocated to the convertible instrument.

15. Special requirements exist if the conversion rate is variable or a beneficial conversion rate is contingent on the occurrence of an event. Contingent BCFs should generally be measured using the commitment-date stock price, but not recognized until the contingency is resolved. If the terms do not permit the issuer to compute the number of shares that the holder would receive if the contingent event occurs and the conversion price is adjusted, the computation should be made when the contingent event occurs. Contingent BCFs that become convertible only upon the occurrence of a future event or that involve changes to conversion terms triggered by a future event that is outside the control of the issuer should be measured when the triggering event occurs. For example, if the instrument is not convertible at the commitment date, but will become convertible and that conversion feature will be beneficial if an initial public offering is completed, the intrinsic value of the beneficial conversion feature is calculated at the commitment date using the stock price as of that date. However, that amount would only be recorded at the date an initial public offering is completed.

16. By way of background, the guidance on BCFs originated in a Securities and Exchange Commission (SEC) speech in 1997 which was then codified into EITF Topic No. D-60, “Accounting for the Issuance of Convertible Preferred Stock and Debt Securities with a Nondetachable Conversion Feature.” Topic D-60 provided the SEC staff view that a BCF should be recognized and measured by allocating a portion of the proceeds equal to the intrinsic value of that feature to paid-in capital. For convertible preferred stock, the value of the BCF is recorded in a manner analogous to a dividend on the preferred shares and is recognized as a return of capital to preferred shareholders over the minimum period in which those shareholders could realize that return using the effective interest method. For
convertible debt securities, the resulting discount increases the effective interest rate and is reflected as interest expense over the period from the issue date through the date the security is first convertible.

17. At the time EITF 98-5 was debated, several alternatives were considered by the EITF. One alternative was not separating the BCF. However, the SEC staff indicated that view was unacceptable and that nondetachable BCFs that exist at issuance should result in a charge to earnings or EPS, depending on the nature of the convertible security. Others that supported separation believed that recognition of the value of BCF more appropriately reflects the substance of the arrangements, as the discount effectively represents an additional interest or dividend. They noted that the existence of the BCF may effectively enable the issuer to further lower the interest rate on debt or reduce the dividend yield on preferred shares.

18. In addition, the EITF considered two separation methods for convertible debt with BCFs—the intrinsic value method and the relative fair value method. Proponents of the relative fair value method cited the following in support of that approach:

(a) The relative fair value approach produces an in-the-money charge which is fairly measured relative to the other attributes of the instrument and avoids the arbitrary limitation that is present in applying the EITF D-60 intrinsic value method in those situations in which the intrinsic value exceeds the offering proceeds (that is, if the intrinsic value of the BCF is greater than the proceeds allocated to the convertible instrument, the amount of the discount assigned to the BCF is limited to the amount of the proceeds allocated to the convertible instrument).

(b) Use of an intrinsic value method should be restricted. While an intrinsic value method for employee stock awards was an acceptable alternative to the fair value model (at that time), FASB Statement No. 123, Share-Based Payment, states that the fair value method is preferable.

(c) It provides a model that would accommodate even more complex instruments, such as an embedded BCF combined with detachable warrants.
19. A fair value method for separating convertible debt with BCFs was considered again by the EITF in Issue 00-27. However, in both cases, the Task Force ultimately concluded that a fair-value-based measurement of the embedded conversion option was not practicable.

**Assessment of Convertible Debt under Topic 815 Derivative Guidance**

20. The next standard to affect the accounting for convertible debt was FAS 133, issued in 1998. Convertible debt was affected by Statement 133 because it applies broadly to all derivatives regardless of whether they are freestanding or embedded in a hybrid instrument. Topic 815, Derivatives and Hedging, (originally issued as FASB Statement 133) requires bifurcation of hybrid instruments containing embedded derivatives that are not clearly and closely related to the host contract. Under this guidance, when a conversion option is embedded in convertible debt (that is, it is not in the form of detachable warrants), an issuer of convertible debt or convertible preferred stock must determine whether the option must be bifurcated.

21. The first step in this analysis is determining whether the embedded conversion option would meet the definition of a derivative if freestanding. Generally, if the underlying securities are readily convertible to cash, such as publicly traded common shares, or there is a net settlement provision, the embedded conversion option would meet the definition of a derivative. An embedded conversion option may not meet the definition of a derivative if, for example, the contract will be gross-share-settled and the entity issuing the equity share is a private company such that the underlying is not considered readily convertible to cash.

22. If the embedded conversion option meets the definition of a derivative, the next step is to determine if it qualifies for the scope exception related to equity instruments of the issuer. Paragraph 815-10-15-74 provides an exception to derivative accounting for contracts issued or held by the reporting entity that are both of the following:

   a. Indexed to the entity’s own stock
   b. Classified in stockholders’ equity in its statement of financial position.
23. As explained in paragraph 286 of Statement 133’s basis for conclusions, the scope exception was created as an interim measure in light of the agenda project related to distinguishing liabilities from equity, which was active at that time. The scope exception explained that until that project was completed, contracts that provided for settlement in shares but that were indexed in part or in full to something other than the entity’s own stock would be accounted for as derivative instruments if they met the definition of a derivative.

24. Subtopic 815-40, Derivatives and Hedging—Contracts in Entity’s Own Equity, provides guidance for evaluating whether an instrument is indexed to, and potentially settled in, an entity’s own shares for the purposes of determining whether the embedded conversion option qualifies for the scope exception for contracts in an entity’s own equity. The guidance related to whether the instrument is indexed only to the entity’s own stock in Subtopic 815-40 originated in EITF 07-5. It requires a two-step evaluation of exercise contingencies and settlement adjustments based on the terms of the contract. Memo 7 provides more detail on EITF 07-5.

25. If an embedded conversion option is indexed to the entity’s own shares, an issuer must then evaluate whether the option would be classified in equity if it were freestanding. The guidance related to this evaluation originated in EITF 00-19. Contracts that could require the issuer to cash settle (even if this could only occur under a remote scenario) are assets or liabilities, but contracts that are settled by gross physical delivery of shares or net share settlement may qualify as equity instruments. If a contract requires physical settlement in shares, the analysis is simplified under Subtopic 815-40 if the convertible debt is considered conventional. An instrument is considered conventional only if it provides the holder with the option to convert into a fixed number of shares or equivalent amount of cash (at the issuer’s option). If conventional, the issuer is not required to evaluate additional criteria to determine whether it has the practical ability to settle in shares.

26. As a result, a conversion option would require bifurcation under Topic 815 if one of the following conditions exists:

(a) It is considered indexed to something other than the value of the entity’s own shares (for example, the conversion feature has a provision that requires the issuer
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to adjust the conversion price if it issues the same securities to another investor at a lower conversion price, commonly known as a *down round* feature)

(b) It requires net cash settlement or can be settled in cash at the holder’s option

(c) It requires share settlement and both (a) it is not considered conventional and (b) it does not meet the additional criteria demonstrating the practical ability to settle in shares.

27. If bifurcated, the conversion option would be measured (initially and subsequently) at fair value and the remaining proceeds would be allocated to the debt component.

**Convertible Debt with a Cash Settlement Feature**

28. In 2002, the EITF revised some of the conclusions in EITF 90-19 for convertible debt with a cash settlement feature through an update of the issue as a result of the issuance of Statement 133 and EITF 00-19. This guidance on derivatives changed the accounting conclusion in EITF 90-19 for Instrument A because it is required to be cash settled, therefore requiring bifurcation into two liabilities. In addition, for Instrument C, the EITF determined that if the conversion spread feature meets the exception in Statement 133 to be considered equity, it would be more consistent with EITF 00-19 not to adjust the carrying amount of Instrument C for changes in the value of the issuer’s shares. Therefore, an issuer would account for Instrument C the same as a conventional convertible bond unless the issuer elects to settle the conversion spread with a cash payment. At the same time, the EITF clarified that the if-converted method should not be used to determine the EPS treatment of convertible debt issued in the form of Instrument C. Instead, there would be no adjustment to the numerator in the EPS computation for the cash-settled portion of Instrument C because that portion of the instrument would always be settled in cash. The conversion spread should be included in diluted EPS based on guidance in FASB Statement No. 128, Earnings per Share, and EITF Topic D-72, “Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share,” related to contracts that may be settled in stock or cash.² This resulted in convertible debt

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² This guidance requires that if an entity issues a contract that may be settled in common stock or in cash at the election of either the entity or the holder, the determination of whether that contract shall be reflected in the
issued in the form of Instrument C having a less dilutive impact when calculating diluted EPS than other types of convertible debt.

29. As a result of the beneficial treatment of such instruments for both income and EPS, and the proliferation of convertible debt instruments that had been issued in the form of Instrument C under EITF 90-19, questions were raised as to whether the accounting guidance in EITF 90-19 appropriately reflected the economic effects of those instruments. In addition to Instrument C, a type of convertible debt referred to as Instrument X became commonplace. The term Instrument X was coined in a December 2003 SEC staff speech to refer to convertible debt that the issuer may satisfy entirely in shares, cash, or any combination of shares and cash upon conversion.

30. To address these issues, in 2008, the FASB issued FASB Staff Position APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upo

Conversion (Including Partial Cash Settlement)* (codified in Subtopic 470-20), which applies to convertible debt instruments that, by their stated terms, may be settled in cash or in a combination of cash or stock upon conversion. The guidance applies to any convertible debt instrument that has any possibility of partial cash settlement, even if the cash settlement is for a small portion of the overall conversion value, and does not consider the issuer’s intended method of settlement. The guidance also applies to convertible preferred stock accounted for as a liability.

31. Under this guidance, convertible debt instruments that give the issuer the ability to settle in cash must be separated into two components in a manner that results in the debt component reflecting the interest cost at the rate of similar nonconvertible debt. Separation is executed by first determining the liability component based on the fair value of a similar liability excluding the conversion option (but including any other embedded features), with the remainder of proceeds attributed to the equity component. Generally, a present value technique would be used to determine the fair value of the debt component. The interest computation of diluted EPS shall be made based on the facts available each period. It shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant provisions of this Topic) if the effect is more dilutive. The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.
expense recognized by the issuer is the combination of the coupon and the amortization of the debt discount (using the interest method) that results from the allocation of proceeds to the equity component.

32. The issuance of FSP APB 14-1 resulted in the nullification of EITF 90-19.

**Navigation under Current GAAP for Convertible Debt Instruments**

*Initial Recognition and Measurement*

33. Based on all of the guidance summarized above, upon issuance of a convertible debt instrument, an issuer must assess the instrument using the navigation in the flowchart below.³

³ Adapted from a table in PwC’s 2013 *Guide to Accounting for Financing Transactions*. 
34. There are two alternative paths depending on the outcome of the assessment of the instrument under the bifurcation guidance in Topic 815. The evaluation starts with whether the convertible debt instrument contains an embedded conversion option that must be accounted for as a derivative under Topic 815. If so, the convertible debt is bifurcated into a conversion feature (liability at fair value) and remaining debt component (liability at amortized cost). Alternatively, in this scenario where the bifurcation gives rise to two liabilities, the fair value option may be elected for the overall instrument. If convertible debt is bifurcated into two liabilities, and the remaining debt component has any other embedded features, those must be evaluated for potential bifurcation. If other embedded derivatives require bifurcation, they must be accounted for together with the conversion feature as a single compound derivative (a liability) at fair value.

35. If the convertible instrument does not require bifurcation under Topic 815 because it meets the scope exception related to instruments indexed to or settled in an entity’s own shares, the issuer must determine whether the convertible debt has other features that require separation under specialized GAAP (e.g., beneficial conversion feature, cash conversion feature). In terms of sequencing, after the evaluation of a convertible debt instrument under Topic 815, the issuer must evaluate the instrument under guidance for convertible debt with cash settlement features. If that model does not require separation, then the convertible instrument is evaluated under the BCF model. If either of those specialized models requires separation, the issuer must separate the instrument into a debt component (liability) and equity component. The issuer would measure the components in accordance with appropriate guidance. It should be noted that at each reporting date, the entity must assess whether the instrument continues to meet the scope exception in Topic 815 by reassessing under the guidance in Subtopic 815-40 (formerly EITF 00-19 and 07-5) to qualify for equity classification.4

4 In the case of gross-share-settled convertible debt instruments issued by nonpublic entities, the navigation process is slightly different. When evaluating whether an embedded conversion option meets the definition of a derivative, private company issuers of convertible debt instruments may conclude that the embedded derivative does not meet the characteristic of a derivative related to net settlement, if the underlying shares are not readily convertible to cash. If the instrument could be net share settled in whole or part (e.g., Instrument C), the instrument would meet net settlement and would have to be tested under the scope exception related to an entity’s own shares. If not, and the convertible debt has a BCF, that model would apply and the embedded option would not be tested for equity classification under Subtopic 815-40.
36. Under this path, which gives rise to separate debt and equity components, the issuer must also evaluate the combined instrument for embedded derivatives beyond the conversion options that are required to be bifurcated under Topic 815. *Evaluation* of the existence of other embedded derivatives (beyond the conversion feature) occurs before any separation; however, actual *bifurcation* of embedded derivatives would occur after separation of the conversion feature.

37. Embedded features determined to not be clearly and closely related to the debt host would be measured as a separate liability from the debt host at fair value. For example, if the instrument has a call option, it would need to be assessed under Topic 815’s guidance for potential bifurcation. In many cases, the call option would be deemed to be clearly and closely related to the debt. However, if the call option has unusual terms that trigger bifurcation, that call option would be bifurcated and measured at fair value as a derivative. The issuer would not be permitted to measure the call option together with the equity component (the conversion option). A scenario in which a convertible debt instrument has both a conversion option requiring separation and an embedded derivative requiring separation gives rise to three components—a debt host (liability at amortized cost), a derivative liability (at fair value), and an equity feature.

38. An issuer of convertible debt may elect the fair value option under Subtopic 825-10, Financial Instruments—Overall (formerly FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*), only if a convertible debt instrument that contains a nondetachable convertible feature is not required to be separated into debt and equity components. Debt with detachable warrants that are separated based on relative fair value is eligible for the fair value option. However, convertible debt instruments that are partially classified in equity (for example, convertible debt with a BCF) are not eligible for the fair value option under Subtopic 825-10. The basis for conclusions in Statement 159 notes that the reason for this prohibition is that changes in the fair value of any contract that, for whatever reason, is reported in shareholders’ equity, in whole or in part, should not affect earnings. However, if the BCF is contingent (and therefore not recognized in equity), the fair value option may be elected.
Derecognition

39. Derecognition guidance for convertible debt has been cited as complex and difficult to understand. Because there are different recognition and initial measurement principles for each convertible debt model, different guidance must be applied upon conversion or early redemption of each type of instrument. As detailed in Appendix B, the accounting upon conversion or early redemption of convertible debt instruments differs depending upon the type of instrument and the separation model used upon initial measurement.

40. As a result, in a conversion situation, one model (traditional convertible debt) results in recognition of no gain or loss while all other models (bifurcated derivative, cash conversion, and BCF) result in recognition of a gain or loss, but the gain or loss is computed differently. In an early redemption situation, only the cash conversion model requires allocation of consideration based on the fair value of the consideration; the BCF model requires allocation based on the extinguishment-date intrinsic value of the conversion option and allocation is obviated for traditional convertible debt because there is no initial recognition of an equity component.

41. In addition, specific guidance exists for induced conversions that must be considered for convertible debt accounted for as traditional convertible debt and under the cash conversion model. This would apply when conversion privileges are changed or additional consideration is paid to debt holders for the purpose of inducing prompt conversion of the debt to equity securities. If conversion is induced, a loss would be recognized equal to the fair value of all securities and other considerations transferred in the transaction in excess of the fair value of consideration issuable in accordance with the original conversion terms. The accounting upon derecognition for those instruments under the cash conversion model would then be applied using the fair value of the consideration that was issuable in accordance with the original conversion terms.

42. The following flowchart summarizes the current requirements.5

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5 Adapted from draft paper on “Reducing Complexity in the Accounting for Convertible Debt” by Switter and Lott. The flowchart excludes convertible debt bifurcated into a debt host and a derivative liability.
1 A substantive conversion feature is at least reasonably possible of being exercised in the future.