



LETTER OF COMMENT NO.

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Mr. Russell G. Golden  
Director of Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7,  
P.O. Box 5116, Norwalk, CT 06856-5116

**File Reference: Proposed FSP APB 14-a**

Dear Mr. Golden:

We appreciate the opportunity to comment on the proposed FASB Staff Position APB 14-a, *Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)* (the "FSP"). As an issuer of convertible securities that may be settled in cash upon conversion, as an underwriter of net cash settled convertible debt issuances for our clients and as a user of financial statements, Merrill Lynch takes great interest in the outcome of this project.

In summary, we do not support the proposed guidance in the FSP that requires separating a convertible instrument into a debt and equity component purely because of an issuer's requirement or choice to settle the instrument (or a portion thereof) in cash. Specifically, the true economic cost to an issuer does not vary based on whether an issuer chooses to deliver shares, cash or some combination thereof to settle the convertible instrument. As a result, we believe that the accounting treatment for convertible instruments whether settled in shares, cash, or some combination thereof should be consistent.

Merrill Lynch is a member of the International Swaps and Derivatives Association ("ISDA") Accounting Committee and frequently participates in the ISDA comment letter

process. As previously articulated in the February 23, 2007 ISDA comment letter to the EITF regarding EITF Issue No. 07-B, not only do we believe that the requirement to bifurcate an equity option in a convertible instrument and classify that option in stockholders' equity will provide misleading information to investors (as it understates both an issuer's legal obligation and a creditor's claim in bankruptcy), we are also concerned with the following consequences of the proposed guidance:

- the FSP represents a broad change to the existing guidance for a class of convertible instruments for which there has not been diversity in practice with regards to the application or interpretation of the rules.
- application of the proposed guidance may create unintended financial consequences to issuers and creditors. Of particular concern is the fact that these adverse financial consequences could arise merely as a result of book adjustments to the financial statements with no impact on the underlying financial condition of the reporting issuer.
- The FSP results in significant differences in financial reporting for securities that are economically equivalent, thereby reducing comparability across issuers. Specifically, the true economic cost to an issuer does not vary based on whether an issuer chooses to deliver shares, cash or some combination thereof to settle the convertible instrument. We view the difference in gross physically settled convertibles and those permitting an issuer to satisfy a portion of the conversion value in cash as an artificial difference that lacks economic substance.

We outline below some of our more significant concerns with the FSP that we hope the Board will consider as they further deliberate this issue.

#### Broad Change to Existing Guidance

We are troubled by the Board's decision to overturn the guidance in EITF Issue 90-19, *Convertible Bonds with Issuer Option to Settle for Cash Upon Conversion*, for the following reasons:

- We believe that issuers of convertible debt have applied the guidance promulgated by the EITF Task Force in good faith,
- We do not believe that a significant practice issue exists to warrant the level of change proposed in the FSP, and
- We question whether there exists a significant population of financial statement users that will realize any noticeable benefit from the proposed changes.

We do not believe that an FSP is the appropriate method for the broad sweeping changes being proposed to the existing literature for convertibles that require or permit cash settlement. We are also concerned by the Board's piecemeal approach to addressing the accounting for convertible instruments. We question whether the guidance proposed in this FSP as well as the issues being addressed in EITF Issue 07-5, *Determining Whether an Instrument is Indexed to a Company's Own Stock*, are likely to be debated once again as part of the FASB's broader project on liabilities and equity. As a result, we suggest that the FASB postpone issuing narrow guidance directed at only a subset of convertible

instruments and instead debate this issue as part of a more comprehensive approach to addressing all significant issues that pertain to convertible instruments.

### Market Impact

We believe that if approved, the proposed FSP is likely to have significant unintended consequences for those non-investment grade issuers that have used convertible securities in their capital structures. Specifically, we believe that as a result of the FSP, there is a likely possibility that many issuers otherwise considered to be financially solvent will be in jeopardy of violating debt and other covenants, thereby triggering technical defaults, creating market volatility, and allowing investors to trigger remedies against such issuers that include accelerating repayment of principal, etc.

As a result of the FSP, issuers will now be required to report interest expense at the entity's non-convertible debt rate resulting in higher expense compared to what is currently reported today. For many issuers, this requirement may negatively impact their ratio of earnings to fixed charges calculation, which requires interest to be included on a US GAAP basis rather than the actual amount of cash paid. As a result, unless issuers are able to successfully negotiate with investors and restructure the terms of outstanding debt covenants, it is likely that upon adoption of the FSP many issuers may automatically trigger a technical default on outstanding debt covenants. We find this consequence to be extremely punitive for issuers that have historically followed the FASB's well codified framework of guidance on convertibles in good faith, particularly given that there has been no change to the economics of the entity's outstanding convertible securities. While we question whether there exists a significant population of financial statement users that will realize any noticeable benefit from the proposed guidance, we do foresee a population of issuers that will likely suffer negative consequences solely as a result of an accounting change.

In addition to the debt covenant measured by the ratio of earnings to fixed charges, many high-yield issuers also have covenants restricting their use of cash flow for purposes other than funding operating expenses or paying down senior debt ("restricted payment covenant"). Generally, the restricted payment covenant prohibits an issuer from paying dividends (or other distributions to lower ranking claimants on the company). It does however allow for dividend and junior payments to the extent of a measurement of increases in book equity. As a result of the requirement in the FSP to bifurcate the debt and equity components of a convertible debt instrument, an issuer will now be required to record a portion of the proceeds from the issuance of the convertible debt in the equity section of the balance sheet, thereby "increasing its equity base" and cash available to be paid out to those holders junior in payment priority. While the additional payment capacity rewards more junior holders in the capital structure, it is to the detriment of senior note holders; it results not from a substantive change in underlying economics of the company, but purely as the result of an accounting change put forth by the FSP.

## Implementation

The FSP neglects to address certain implementation issues that may ensue as a result of applying the proposed guidance. Specifically, the FSP does not address how to treat a change in the expected life of a convertible debt instrument that may be settled in cash. It is our view that a debt discount should initially be amortized to the first matching put/call date in the instrument. For several reasons however a convertible debt instrument may remain outstanding beyond the anticipated maturity date. Generally, the actual life of a convertible debt instrument which has embedded puts and calls is largely driven by the price of the issuer's stock as of the put/call date. If the issuer's stock price is below the conversion price, generally, holders will exercise their put right. If, however, an issuer's stock price is at or above the conversion price, holders will generally not exercise the put right (i.e., conversion value is greater than the value which would be received if a holder exercised its put). The issuer's decision whether or not to exercise its call option is also dependent, in part, on stock price. If the conversion option is in the money, it is generally not economic for the issuer to call the security as it would result in non-deductible equity being delivered to holders in exchange for a security which was tax deductible (i.e., why replace "deductible equity" for non-deductible equity?). Consequently, ignoring the conversion option for purposes of determining the "expected life" will necessarily lead to a disparity from the actual life of the security.

While there remains ambiguity as to how an issuer would report interest expense subsequent to the anticipated maturity date, it is our view that reported interest expense would step down to the actual yield on the instrument. We suggest that the FSP clarify how this issue as well as other issues related to a change in the expected life should be handled.

## Transition

Given that issuers have followed the guidance as established by the EITF Task Force in good faith when accounting for convertible instruments that require or permit cash settlement, we recommend that the Board provide for prospective application for those instruments: (1) that are no longer outstanding as of the effective date (2) that are modified to only provide for gross share settlement or (3) have been included in diluted earnings per share using the if-converted method and will only be settled in shares in the future. We fail to see the benefit that will be provided to users of financial instruments for this population of convertible instruments when compared to the cost of obtaining the information. We believe that obtaining the valuations necessary for retrospective application may be particularly difficult for those non-investment grade issuers who have historically used convertible instruments as the main source of funding in their capital structure.

Finally, should the Board not agree with our suggestion regarding prospective application of the FSP, we strongly encourage the FASB to delay the effective date to fiscal years beginning after December 15, 2008. A one-year deferral will provide issuers the time necessary to gather the information for retrospective application and to modify

outstanding debt covenants that might otherwise place issuers in a technical default upon adoption of the FSP.

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Thank you for the opportunity to comment on the FSP. We hope the Board will give consideration to our comments as they finalize their guidance. Please do not hesitate to contact me with any questions on our comments.

Sincerely,

/s/David Moser  
Managing Director