

MINUTES



**To:** Board Members

**From:** Yust (ext. 442)

**Subject:** Proposed FSP APB 14-a, *Accounting for Convertible Debt Instruments that May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*

**Date:** April 8, 2007

**cc:** Bielstein, MacDonald, Golden, Cosper, Lott, Stoklosa, Malcolm, C. Smith, Yust, Liabilities and Equity Team, Earnings per Share Team, Wilkins, Paul, Bossio, J. Johnson, Allen, Klimek, Chookaszian, Posta, Gabriele, Leisenring (IASB), Gavin Francis (IASB), Liz Figgie (IASB), FASB Intranet

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Topic: Proposed FSP APB 14-a, *Accounting for Convertible Debt Instruments that May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*

Basis for Discussion: Memorandum No. 5 and Supplement to Memorandum No. 5

Length of Discussion: 8:25 a.m. to 9:40 a.m.

Attendance:

Board members present: Herz, Crooch, Linsmeier, Seidman, Smith and Young (participating by phone)

Board members absent: Batavick

Staff in charge of topic: B. Stevens

Other staff at Board table: Golden, Cosper, C. Smith, Yust

Outside participants: None

### Summary of Decisions Reached

At the March 26, 2008, Board meeting, the Board discussed comments received on the proposed FASB Staff Position (FSP) APB 14-a, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*. The Board reached the following decisions in addressing the comments received on the proposed FSP:

1. The scope of the proposed FSP was reaffirmed.
2. The guidance on recognition and initial measurement in the proposed FSP, including the liability-first separation methodology, was reaffirmed.
3. Transaction costs should be allocated between the liability and equity components in proportion to the allocation of the proceeds.
4. The guidance on subsequent measurement in the proposed FSP was reaffirmed.
5. The guidance on accounting for modifications and derecognition in the proposed FSP was reaffirmed.
6. The final FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years.
7. The final FSP should be applied retrospectively to all periods presented.
8. The provisions of FASB Statement No. 34, *Capitalization of Interest Cost*, should be applied to all periods in which the instrument was outstanding; however, entities should not re-perform impairment tests for prior periods in connection with retrospective application.
9. The guidance in the final FSP does not affect the determination of whether the liability component should be presented as a current liability or a long-term liability in the balance sheet under other applicable U.S. GAAP.
10. The final FSP will contain explicit disclosure requirements.
11. The staff should proceed to a draft of a final FSP for vote by written ballot.

### Objectives of Meeting:

1. The objective of the meeting was for the Board to discuss (a) the significant issues raised by respondents in the comment letters received on the proposed FSP and (b) to redeliberate issues relating to the proposed FSP. The objectives of the meeting were met.

## Matters Discussed and Decisions Reached:

2. Mr. Stevens noted that comments were received on substantially all aspects of the proposed FSP. He stated that he would provide a brief introduction to each of those topics and then turn it over to the Board for discussion. Additionally, the Board will be asked to vote on 6 specific questions.

## **Overall Position on the Proposed FSP**

3. Staff Comments: Mr. Stevens stated that the majority of comment letter respondents were opposed to the guidance in the proposed FSP. A significant number of respondents that opposed the proposed FSP asserted that (a) the current accounting treatment for such instruments (that is, application of paragraph 12 of APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*) is correct, (b) the accounting should not be changed for a subset of convertible instruments, and (c) a requirement to separate the liability and equity components of convertible debt instruments will increase complexity in financial reporting. A significant number of those respondents also asserted that the accounting for convertible instruments within the scope of the proposed FSP should not be changed until the Liabilities and Equity project is completed.
4. Board Comments: Mr. Herz stated that he had some sympathy for opponents of the proposed FSP because of his narrow view of equity, and he preferred the original “indexed debt” accounting guidance in EITF Issue No. 90-19, “Convertible Bonds with Issuer Option to Settle for Cash upon Conversion,” before it was amended in 2002. However, he believed that the proposed FSP still represented a significant improvement in financial reporting. Mr. Smith agreed that the guidance in Opinion 14 was never intended to apply to many of the convertible instruments currently seen in practice, so the proposed FSP would help address what he considers to be an accounting abuse.

## **Scope**

5. Staff Comments: Mr. Stevens stated that some respondents recommended that the scope be expanded to all convertible debt instruments. Those respondents

asserted that physically-settled convertible debt instruments are economically equivalent to cash-settleable convertible debt instruments.

6. Board Comments: Ms. Seidman agreed that expanding the scope of this guidance is a valid suggestion but went beyond the primary objective of this project. Mr. Linsmeier reiterated the need for the liabilities and equity project to address these and other concerns. No Board members supported broadening the scope of the FSP.

## **Recognition and Initial Measurement**

### ***Liability-First Separation Methodology***

7. Staff Comments: Mr. Stevens noted that feedback was mixed among those comment letter respondents who expressed a preference for a particular separation methodology. The comment letter respondents who did not prefer the liability-first separation method typically indicated that (a) it would be difficult to apply because entities would be unable to estimate their borrowing rates and (b) it would introduce a new method of separation into U.S. GAAP. Many of the respondents who preferred an equity-first separation method observed that such an approach is consistent with the issuer's initial recognition when an embedded conversion option is required to be separately accounted for as a derivative under Statement 133. In addition, a number of respondents observed that the value of the conversion option is a key element to pricing convertible bonds in their entirety.
8. Mr. Stevens stated that the staff supports the liability-first separation method. He observed that such treatment is consistent with the separation approach that is already being broadly applied to physically-settled convertible debt instruments under International Accounting Standard (IAS) 32, *Financial Instruments: Presentation*. Accordingly, he observed that the application of the liability-first separation approach has already been field tested throughout much of the world. Mr. Stevens also described additional measurement complexities associated with an equity-first separation methodology arising from contingency features that are typically included in the conversion option.

9. Board Comments: Ms. Seidman believes that many of the comments were valid points and that there were advantages and disadvantages to the various separation approaches. However, she agreed that because a particular methodology needs to be selected, the Board should support the convergent methodology. Mr. Linsmeier was interested in an approach whereby entities would perform both the liability-first and equity-first separation methodology and use the approach that is most reliable. However, he acknowledged that the joint features in many convertible instruments would not necessarily be allocated comparably or consistently, so he stated he would support the staff recommendation. Mr. Smith believed the staff recommended approach would be the simplest methodology to apply. None of the Board members supported changing the liability-first separation guidance in the proposed FSP.

### ***Income Taxes***

10. Staff Comments: Mr. Stevens stated that one respondent disagreed with the guidance in the proposed FSP that its application may result in a basis difference associated with the liability component that represents a temporary difference under FASB Statement No. 109, *Accounting for Income Taxes*. That respondent indicated that the recognition of interest cost from amortizing a debt discount should be treated as a permanent difference under Statement 109.
11. Board Comments: Mr. Smith observed that the EITF has discussed this topic recently in the context of convertible debt with beneficial conversion features. Mr. Stevens stated that the guidance in the proposed FSP is consistent with the consensus reached in that Issue (EITF Issue No. 05-8, “Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature”). Mr. Stevens noted that the guidance in the proposed FSP is also consistent with the income tax accounting treatment under IAS 12, *Income Taxes*, for convertible debt instruments that are separated into liability and equity components under IAS 32. None of the Board members supported changing the income tax accounting guidance in the proposed FSP.

### ***Transaction Costs***

12. Staff Comments: Mr. Stevens stated that some respondents requested clarification of the accounting for transaction costs relating to the issuance of instruments that are within the scope of this project. Those respondents asked whether transaction costs should be allocated between the liability and equity components and accounted for as debt issue costs and equity issue costs, respectively.
13. Board Vote: Messrs. Herz, Batavick (by proxy), Crooch, Smith, Young, and Ms. Seidman voted to support the staff recommendation to allocate transaction costs between the liability and equity components. Mr. Linsmeier stated that his preference would be to immediately expense all transaction costs, but he would not object to allocating the transaction costs and accounting for those costs under existing U.S. GAAP.
14. Board Comments: Ms. Seidman agreed with the staff recommendation that the accounting for transaction costs relating to instruments within the scope of this FSP should be consistent with the accounting for debt and equity issuance costs elsewhere in U.S. GAAP.

### **Subsequent Measurement**

15. Staff Comments: Mr. Stevens stated that the proposed FSP specified that the excess of the principal amount of the liability component over its initial fair value should be amortized to interest cost using the interest method under APB Opinion No. 21, *Interest on Receivables and Payables*. The proposed FSP indicated that the debt discount should be amortized over the expected life of a similar liability that does not have an associated equity component (considering the effects of prepayment features other than the conversion option). That proposed guidance also indicated that if an issuer uses an income approach valuation technique for purposes of measuring the fair value of the liability component at initial recognition, the issuer should consider the periods of cash flows used in that fair value measurement when determining the discount amortization period.
16. Mr. Stevens stated that a number of respondents requested additional guidance on determining the expected life of a debt instrument with embedded prepayment

- options. Others requested guidance on whether the expected life should be subsequently reassessed. Additionally, some respondents disagreed with the guidance in the proposed FSP stating that instruments within its scope are not eligible for the fair value option.
17. Board Comments: Mr. Smith questioned why an entity should exclude the effects of the equity component when estimating the expected life of the liability component. He suggested that the expected life of the liability component could be based on the expected life of the convertible instrument in its entirety, including the equity component. Mr. Stevens stated that the staff did not recommend that change to the guidance in the proposed FSP because (a) it would potentially require an entity to model out future movements in its own stock price and (b) the resulting financial statement amounts would frequently be based on management's intent regarding when to exercise its call option (which essentially forces early conversion when an instrument is in-the-money).
18. Mr. Golden acknowledged that there are advantages and disadvantages of each alternative approach to separation and subsequent measurement. However, under the guidance in the proposed FSP the expected life of the liability component that was estimated for purposes of measuring that component would be consistent with its subsequent amortization period.
19. Messrs. Herz, Batavick (by proxy), Crooch, Linsmeier, Young, and Ms. Seidman agreed with the staff recommendation to reaffirm the guidance on subsequent measurement in the proposed FSP, which excludes the effects of the equity component when estimating the expected life of the liability component. Those Board members agreed that the final FSP should clarify that the expected life of the liability component should not be reassessed in subsequent periods. Mr. Smith expressed his belief that additional guidance on the measurement of the liability component could be provided, but stated that he would not object to the staff recommendation.

## **Modifications and Derecognition**

20. Staff Comments: Mr. Stevens stated that the proposed FSP provided guidance on accounting for modifications and derecognition of instruments within its scope. That guidance was intended to (a) specify how the consideration exchanged should be allocated between the liability and equity components at settlement and (b) refer to other U.S. GAAP for guidance on debt modifications, induced conversions, and other related issues. Some of the respondents disagreed with the guidance in the proposed FSP prohibiting an entity from recombining the components of an instrument if its terms are modified in a manner that does not result in derecognition of the original instrument. One respondent believes that the guidance on accounting for induced conversions in FASB Statement No. 84, *Induced Conversions of Convertible Debt*, should not apply to instruments within the scope of this project. Another respondent suggested that, upon settlement by a conversion, the issuer should expense any unamortized debt discount instead of allocating the settlement consideration to the liability and equity components.
21. Board Comments: No Board members supported changing the guidance on modifications and derecognition that was contained in the proposed FSP.

### **Effective Date**

22. Staff Comments: Mr. Stevens stated that the proposed FSP, which was released for exposure on August 31, 2007, would have been effective for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Substantially all comment letters requested that the effective date be delayed by at least one year to provide entities with more time to understand and implement the guidance.
23. Board Vote: The Board unanimously voted (Mr. Batavick voted by proxy) to make the final FSP effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years.
24. Board Comments: Mr. Smith questioned whether the effective date should be for fiscal years **ending** after December 15, 2008, rather than fiscal years **beginning** after that date. Mr. Golden stated that, historically, the Board has specified an

effective date for periods ending after a particular date when the newly issued guidance is predominantly focused on balance sheet presentation. In contrast, this FSP will often have a significant affect on both the balance sheet and the income statement.

25. Ms. Seidman observed that the proposed amendment to FASB Statement No. 128, *Earnings per Share*, may be effective for years beginning after December 15, 2008. Because some instruments within the scope of this FSP may also be affected by the earnings per share guidance in that proposed amendment to Statement 128, she expressed her belief that this FSP should be effective for years beginning after December 15, 2008, which would prevent entities from having to adopt this FSP and the proposed amendment to Statement 128 in successive quarters.

### **Transition**

26. Mr. Stevens stated that the proposed FSP specified that its guidance should be applied retrospectively to all periods presented. A majority of comment letter respondents objected to retrospective application. Many respondents requested that the proposed FSP be applied prospectively by grandfathering instruments that are outstanding at the effective date. A significant number of respondents also requested that retrospective application not be required for (a) instruments that are settled prior to the effective date, (b) instruments that are modified to remove the cash-settlement feature prior to the effective date, and (c) instruments that have been reflected in diluted earnings per share using the if-converted method. The Board was asked to discuss the following transition alternatives:

**Retrospective Transition Alternative A** - Full retrospective transition (consistent with the Proposed FSP)

**Retrospective Transition Alternative B** - Same as Alternative A, except that entities are not required to apply the guidance in the FSP to instruments that are no longer outstanding at the effective date.

**Retrospective Transition Alternative C** - Same as Alternative A, except that entities are not required to apply the guidance in the FSP to instruments (a) that are no longer outstanding at the effective date or (b) that have been modified prior to the effective date such that they may no longer be settled in cash (or other assets) upon conversion, including partial cash settlement. However, if an entity modifies a convertible debt instrument prior to the effective date such that it may no longer be settled in cash (or other assets) upon conversion, including partial cash settlement, the if-converted method of computing diluted earnings per share must be applied to that instrument for all periods presented.

**Retrospective Transition Alternative C'** - Same as Alternative C, except that if an entity modifies a convertible debt instrument prior to the effective date such that it may no longer be settled in cash (or other assets) upon conversion, including partial cash settlement, the entity would not be required to retrospectively adjust diluted earnings per share in the financial statements. Rather, it would be required to **disclose** pro forma diluted earnings per share that reflects the application of the if-converted method of computing diluted earnings per share to that instrument for all periods presented.

**Retrospective Transition Alternative D** - Same as Alternative A, except that entities are not required to apply the guidance in the FSP to instruments that **both** (a) have been modified prior to the effective date such that they may no longer be settled in cash (or other assets) upon conversion, including partial cash settlement and (b) have previously been reported using the if-converted method of computing diluted earnings per share for all prior periods presented.

27. Mr. Stevens stated that some constituents have asked whether, for entities with qualifying assets, the guidance in FASB Statement No. 34, *Capitalization of Interest Cost*, should be applied in prior periods under retrospective application. If interest cost is eligible for capitalization in prior periods, it would often increase

- the carrying amounts of an entity's long-lived assets and reporting units. Consequently, constituents have also asked whether any impairment tests that were performed in prior periods should be reperformed under retrospective application based on the revised carrying amounts of the related assets.
28. Board Votes: Messrs. Batavick (by proxy), Crooch, Linsmeier, and Smith voted that the guidance in the final FSP should be retrospectively applied to all periods presented (Retrospective Transition Alternative A). Mr. Young stated that he would support either Retrospective Transition Alternative A or Retrospective Transition Alternative D. Mr. Herz and Ms. Seidman stated their preference was Retrospective Transition Alternative C, but they would not object to a full retrospective transition (Alternative A).
29. Messrs. Herz, Crooch, Linsmeier, Young, Smith, and Ms. Seidman voted to clarify that for purposes of retrospectively applying the guidance in the final FSP, the provisions of Statement 34 should be applied to all periods in which the instrument was outstanding. However, entities should not re-perform impairment tests for periods prior to the effective date. Mr. Batavick did not vote (his proxy did not address this particular item).
30. Board Comments: Mr. Smith stated that it was regrettable to change the rules for entities that considered the previous accounting treatment in reaching their decision to issue instruments within the scope of this FSP. However, he believes that full retrospective transition is appropriate to level the playing field across companies affected by this FSP.
31. Mr. Herz does not believe these instruments will continue to be issued, so he was not convinced that full retrospective would provide the most comparable information. Ms. Seidman stated that a consistent trend may not exist going forward, even with a full retrospective transition, because some entities will extinguish the instruments.

## **Other Comments**

### ***Balance Sheet Presentation***

32. Staff Comments: Mr. Stevens stated that convertible debt instruments that require settlement of the principal amount in cash upon conversion are presented as current liabilities in a classified balance sheet whenever the instrument is currently convertible (or will become convertible within one year from the balance-sheet date). He noted that some constituents have requested clarification of whether entities should continue to consider all terms of instruments within the scope of this project (including conversion terms) for purposes of determining whether the liability component should be presented as a current liability or a long-term liability in a classified balance sheet.
33. Mr. Stevens proposed that the final FSP clarify that its guidance does not affect an issuer's determination of whether the liability component should be classified as a current liability or a long-term liability. For purposes of applying other applicable U.S. GAAP to make that determination, all terms of the convertible instrument (including the equity component) must be considered. Additionally, the balance sheet classification of the liability component would not affect the subsequent measurement of that component under the FSP.
34. Board Comments: The Board agreed with the staff recommendation that the proposed FSP clarify that its guidance does not affect an issuer's determination of whether the liability component should be classified as a current liability or a long-term liability.

### ***Disclosures***

35. Staff Comments: Mr. Stevens stated that some user constituents recommended that the FSP include explicit disclosure requirements. The Board was asked to consider the following disclosure alternatives:

#### **Disclosure Alternative A**

- a. The instrument's principal amount, unamortized discount on its liability component, and the carrying amounts of its liability and equity components.
- b. The conversion price and the number of shares on which the aggregate consideration to be delivered upon conversion is determined.
- c. The amount by which the instrument's if-converted value exceeds its principal amount at the balance-sheet date, regardless of whether the

- instrument is currently convertible.
- d. The amount of interest cost recognized for the period relating to the contractual interest coupon and amortization of the discount on the liability component, respectively.
  - e. The effective interest rate on the liability component and the remaining period over which the unamortized discount on the liability component will be recognized as interest cost.
  - f. Information about derivative transactions entered into in connection with the issuance of instruments within the scope of this project, including the terms of those derivative transactions, how those transactions relate to the instruments within the scope of this project, the number of shares underlying the derivatives, and the reasons for entering into those derivative transactions. This disclosure is required regardless of whether the related derivative transactions are accounted for as assets, liabilities, or equity instruments.

### **Disclosure Alternative B**

In addition to disclosures required under other applicable U.S. GAAP, the following information shall be disclosed for each annual period for convertible debt instruments within the scope of this FSP:

- a. The carrying amount of the equity component,
- b. The principal amount of the liability component, its unamortized discount, and its net carrying amount,
- c. The remaining period over which any discount on the liability component will be amortized,
- d. The effective interest rate on the liability component, and
- e. The amount of interest cost recognized for the period relating to the contractual interest coupon and amortization of the discount on the liability component, respectively.

36. Board Vote: Messrs. Herz, Crooch, Linsmeier, Young, Smith, and Ms. Seidman voted to require Disclosure Alternative A. Mr. Batavick (by proxy) supported Disclosure Alternative B.

37. Board Comments: Mr. Linsmeier was concerned that certain disclosures may not be provided under Alternative B. He questioned whether all instruments within the scope of the proposed FSP would be within the scope of other U.S. GAAP, such as FSP FAS 129-1. Mr. Stevens believed that all such instruments would be within the scope of Opinion 21 and Statement 129. However, he stated that most, but not necessarily all, of the instruments within the scope of the proposed FSP

would be within the scope of FSP FAS 129-1. Mr. Herz proposed another alternative whereby the final FSP would state that issuers of instruments within the scope of this FSP be required to provide disclosures required by certain other pronouncements, such as FSP FAS 129-1, regardless of whether the convertible instrument is within the scope of that accounting literature. Mr. Stevens observed that such an alternative would effectively be an amendment to the scope of FSP FAS 129-1.

38. Ms. Seidman was concerned that Disclosure Alternative A, which includes certain disclosures required by other U.S. GAAP, could imply that those disclosures are not already required. She suggested that the disclosure guidance in the FSP be worded carefully to avoid that implication. After the Board voted to support Disclosure Alternative A, Mr. Stevens indicated that the disclosure guidance in the FSP will be worded in a manner that is intended to address the concerns raised by Board members at this meeting.

### **Balloting for the Final FSP**

39. Staff Comments: The staff asked if the Board wants to proceed with the balloting process for the final FSP.
40. Board Vote: The Board voted unanimously (Mr. Batavick by proxy) to proceed with the balloting process for the final FSP.

### Follow-up Items:

41. None.

### General Announcements:

42. None.