

FASB Emerging Issues Task Force

Issue No. 05-1

Title: The 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)

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

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

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

AICPA Accounting Interpretation 1, *Debt Tendered to Exercise Warrants*, of APB Opinion No. 26 (AIN-APB26)

*** 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 and it is ratified by the Board.**

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

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 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 or not otherwise currently convertible because of a contingency other than the passage of time. 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 will elect 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.

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?

3. At the March 17, 2005 EITF meeting, the Task Force considered the following four alternatives for this issue:

View A: The instrument's original terms provide for the possibility that an issuer will exercise its call option and, therefore, the conversion is pursuant to the original terms of the instrument. Accordingly, the conversion of the instrument should be treated in the same manner as the conversion of a noncontingently convertible debt instrument. That is, the carrying amount of the debt should be credited to equity upon conversion and no gain or loss should be recognized.

View B: The exercise of the call option changes the conversion privileges of the instrument and provides an inducement for the holder to convert. Accordingly, the conversion should be recognized as an induced conversion under FAS 84.

View B¹: The exercise of the call option changes the conversion privileges of the instrument and provides an inducement for the holder to convert. Accordingly, the conversion should be recognized as an induced conversion under FAS 84. However, the measurement of the inducement expense differs from that under View B.

View C: The exercise of the call option changes the conversion privileges of the original instrument. However, the changes in privileges do not meet the requirements of FAS 84 for an induced conversion and, therefore, the conversion should be recognized as a debt extinguishment under APB 26.

4. At the March 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, above). 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 View C, and certain Board members stated that they would object to the ratification of a View A consensus.

5. Also at the March meeting, the Task Force also 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.

6. The purpose of the following examples is to provide 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 whether the Task Force reaches a consensus on View A or View C because the earnings per share treatment is applied prior to the instrument(s) being converted. The earnings per share treatment is provided to assist Task Force members in their evaluation of the propriety of View A and is not intended to provide earnings per share computational guidance. The examples also illustrate the application of APB 26 to these similar instruments.

7. 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.

Analysis of fact pattern

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 anytime, 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 consideration

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.

Analysis of fact pattern

The holder converted the CoCo pursuant to its original terms and because the conversion of the bond occurred pursuant to these terms, 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.

Analysis of fact pattern under View A

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 one 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 would not have had otherwise.

Based on the tentative conclusion, the conversion of 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 C

Under View C, 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 2 – Scenario #3

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. In contemplation of the transaction, the issuer's stock price increases to \$110. On February 1, 2009, the holder elects to convert the CoCo and receives 10 shares of common stock valued at \$1,100 and those shares are tendered to the acquiring company in exchange for \$1,100.

Analysis of fact pattern

The holder converted the CoCo pursuant to its original terms, and because the conversion of the bond occurred pursuant to those terms, the carrying value 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 #4

On January 1, 2009, the issuer announces that it is selling 100 percent of its outstanding shares for \$110 per share and 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.

Analysis of fact pattern under View A

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 would not have had otherwise.

Based on the tentative conclusion reached on Issue 05-1, conversion of the bond is considered to have occurred pursuant to the CoCo's 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 C

Under View C, 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

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 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 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 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 bond and receives \$1,000 and 0.909 shares of common stock valued at \$100.

Analysis of fact pattern

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 to 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.

Analysis of fact pattern under Issue 05-1, View A

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. Therefore, 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.

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.

Treatment under Issue 05-1, View C

Under View C, 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; comprised of \$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.

If the Task Force were to change its tentative conclusion and reach a consensus on View C, the Task Force also would need to decide whether an instrument that is within the scope of Issue 03-7 should be included or excluded from the scope of this Issue.

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 – 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 4 – 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.

Analysis of fact pattern

The issuer has the right to call the debt at anytime 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.

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 4 – 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).

Analysis of fact pattern under Issue 05-1, View A

The issuer has the right to call the debt at anytime 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.

Based on the tentative conclusion reached on Issue 05-1, 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 Issue 05-1, View C

Under View C, 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 under FAS 128

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)

8. 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 for 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

9. 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 a 2005 issue 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.

10. 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.