FASB Emerging Issues Task Force

Issue No. 05-1

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

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Previously distributed EITF materials: Issue Summary No.1, dated March 1, 2005; Issue Summary No. 1, Supplement No. 1, dated May 27, 2005; Issue summary No. 1, Supplement No. 2, dated September 1, 2005

References:

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

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

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

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150)

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

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

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

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

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

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

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

EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" (Issue 98-5)

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

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

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

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

EITF Issue No. 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues" (Issue 05-7)

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

Background

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

2. To illustrate the underlying issue, consider the following example.

> An entity issues a CoCo 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. This Issue focuses on those circumstances in which the issuer exercises its call during a period when the instrument was not otherwise convertible.

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

minutes), and certain Board members stated that they would object to the ratification of a consensus based on the tentative conclusion reached at the March 2005 meeting.

4. Also at the March 2005 meeting, the Task Force directed the FASB staff to consider the earnings per share treatment for these instruments before the exercise of the call option and then compare that treatment to the earnings per share treatment for instruments with similar terms.

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

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

7. At the September 15, 2005 EITF meeting, Task Force members discussed views that proscribed the accounting treatment depending on whether the shares underlying the conversion were included in diluted earnings per share before the call date, however, the Task Force was divided between treating all conversions in the scope of this Issue as extinguishments and treating only conversions of instruments that did not otherwise contain a substantive conversion contingency as extinguishments. Consequently, the Task Force no longer supported its previous

tentative conclusion and asked the FASB staff to research the operationality of an alternative view that would result in either debt conversion accounting or debt extinguishment accounting depending on whether the instrument, at issuance, contains a substantive conversion feature that is outside the control of the issuer. In response, additional background information is presented about the economic factors that influence the behavior of issuers and investors. Based on that information, three additional views about how to account for a conversion in the scope of this Issue are presented.

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

Scope

9. This Issue applies to the issuance of equity securities to settle a debt instrument that only became convertible upon the issuer's exercise of a call option when the issuance of equity securities is in accordance with the stated terms of the instrument.[1]

Accounting Issue and Alternatives

Issue 1: How the conversion of an instrument that becomes convertible upon the issuer's exercise of a call option should be accounted for.

10. When the conversion value of a convertible instrument exceeds its conversion price, economic theory suggests that an issuer's decision whether to call the instrument (potentially forcing conversion) should focus on the conversion value of the instrument relative to the call price of the debt. However, factors such as the marginal impact of after tax interest payments relative to dividends expected to be paid on the shares may also be relevant. Research published in 1995 suggests that most convertible debt is called as soon as the conversion value of the

[1] FAS 84 provides guidance about conversions pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance to induce conversion and Issue 05-7 provides guidance about modifications to conversion options.

instrument exceeds the call price by a sufficient safety margin so that the risk of being required to pay cash (by virtue of the share price dropping during the period the holder is allowed to elect cash or share settlement) is low.[2] Though there is no empirical evidence that indicates how features common to instruments developed since the 1995 study might impact an issuer's decision to call, the staff believes it is reasonable to conclude that the optimal call strategy should continue to be founded on an analysis of the conversion value relative to the call value, with the marginal impact of additional features considered.

11. It is not normally optimal for an investor to convert a convertible bond to equity prior to maturity. The lower limit to the value of a convertible debt instrument is the higher of its bond value or conversion value. The value of a convertible instrument before its maturity is normally worth more than its lower limit if the issuer cannot call the instrument. The value of a convertible before maturity less the value of its lower limit represents the value of a call option on the stock of the issuer. The investor must give up the bond in order to exercise the call option so the bond value serves as the exercise price. When conversion occurs, the bond value exchanged for equity shares (that is, the exercise price of the call option) becomes at risk to declines in the share price of the issuer. Prior to conversion, the bond value serves as a floor to the value of the hybrid instrument. Additionally, the holder of a convertible bond loses any time value associated with its call option if conversion occurs prior to maturity.

12. Many of the CoCos outstanding in the market today are economically similar to non-contingently convertible debt (that is, the contingencies generally restrict conversion during periods when it is not economical for the investor to convert). An issuer's optimal call strategy and the economic motivations of an investor effectively allow the issuer of a convertible instrument to control the timing of its settlement whether the instrument is contingently or non-contingently convertible. Additionally, a study of more than 200 convertible debt instruments issued from November 2000 through December 2002, approximately 30 percent of which were CoCos, indicated that investors did not require different yields for CoCos and non-contingently

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[2] P. Asquith, "Convertible Bonds are Not Called Late," *Journal of Finance*, Volume L, No. 4, September 1995.

convertible instruments.[3] The study also finds "no difference in…investment banking fees, or market reaction attributable to the contingent feature."

13. However, because it is not possible to anticipate the types of changes that might take place in the convertible debt market, it seems prudent to consider how contingent conversion features might impact the conversion feature embedded in a CoCo upon issuance. The more likely the occurrence of an event that would trigger convertibility, the larger the discount an investor should be willing to accept relative to an otherwise identical non-convertible instrument (that is, the greater the likelihood the contingent events will occur, the more closely the pricing of a contingently convertible instrument will approximate that of an identical instrument that is not contingently convertible). In contrast, if the occurrence of the contingent conversion event is remote, the terms of the instrument should approximate the terms of an otherwise identical nonconvertible instrument.

14. Previously, the Task Force considered the potential impact of this Issue on the following example:

> 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.

15. Many believe the embedded conversion feature described above is a settlement alternative rather than a conversion privilege similar to a traditional convertible debt instrument. Discussions with market participants indicate that an investor would likely value such an instrument similarly to a non-convertible instrument (that is, an investor will not pay for a conversion feature the investor does not expect will be accessible prior to the maturity of the instrument). It was, in part, concern about the potential treatment of this hypothetical instrument

[3] C. Marquardt and C. Wiedman. "Discussion of Earnings Management through Transaction Structuring: Contingent Convertible Debt and Diluted Earnings per Share," *Journal of Accounting Research*, Volume 43, No. 2, May 2005.

that led the Task Force to no longer support its original tentative consensus. If the instrument described above were settled in equity shares (as a result of the issuer's exercise of its call), each of the views described below would require the recognition of expense equal to the difference between the value of the equity instruments issued and the carrying amount of the debt (that is, equivalent to extinguishment accounting). As a result, no further analysis of this hypothetical instrument is presented below.

View A: The issuance of equity securities to settle an instrument that, at issuance, contains a substantive conversion feature should be recognized as a conversion. The issuance of equity securities to settle an instrument that, at issuance, does not contain a substantive conversion feature should be recognized as a debt extinguishment.

16. Proponents of View A believe that the settlement of all convertible instruments should be accounted for consistently. They believe an instrument should be evaluated at issuance to determine whether it is convertible. If an instrument is deemed convertible at issuance, they believe that any subsequent conversion of the instrument must be performed in accordance with a "conversion privilege that existed at issuance" and, therefore, is outside the scope of APB 26. Proponents of View A also believe that evaluating a conversion feature at issuance is practical because much of the information that might be helpful in evaluating the conversion feature should be readily available since much of it is needed to evaluate different forms of financing.

17. Proponents of View A believe that uncertainty impacts the value of a conversion feature but does not change the nature of the instrument (convertible or nonconvertible), irrespective of whether the uncertainty is derived from the likelihood the stock price will increase or the likelihood a given contingency will be satisfied. The value of a conversion feature is a function of the likelihood that it will affect how the instrument is settled and the magnitude of the potential settlement. The value of a conversion feature in a non-contingently convertible instrument is determined, in part, by reference to the likelihood that an issuer's stock price will rise, making conversion economical. The value of a CoCo is also effected by that uncertainty and additional uncertainty, if any, related to the likelihood that the instrument will not become convertible because it fails to satisfy one of the contingent conversion triggers.

18. Some opponents of View A acknowledge that both the risk an issuer's share price will rise and the risk that the instrument will become convertible impact the substance of a conversion feature. However, they believe that, for purposes of this Issue, only the risk that the contingent conversion feature will not be satisfied is relevant. Proponents agree; however, they note that in most cases the risk associated with whether an issuer's share price will increase has no impact on the analysis because it is redundant to the risk that a market price trigger will not be met (that is, the risk that a market price trigger will not be satisfied encompasses the risk that the share price will not increase enough to make conversion economical). Additionally, they argue that isolating the risk would greatly reduce the practical methods available to evaluate the substance of a conversion feature since it would, effectively, require a direct assessment of the contingencies. They believe an assessment that includes both risk that the underlying share price will not increase and risk that the contingent conversion feature will not be satisfied could be performed in a number of different ways, such as by comparing the terms of a CoCo to the terms of an equivalent non-convertible instrument.

19. As discussed in View B, because the risk of non-convertibility in a CoCo may reside outside of its conversion price (for example, in a market price trigger) opponents of View A do not believe evaluating the substance of its conversion feature at issuance provides evidence about whether the settlement of that instrument is in accordance with that conversion feature.

20. Opponents acknowledge that when the likelihood that a conversion feature will impact the settlement of an instrument is reflected solely in the conversion price, as it is in a non-contingently convertible instrument, it is not necessary to evaluate whether a subsequent conversion of the instrument is in accordance with a different conversion feature. In other words, if the share price of the instrument rises enough to make conversion economical, it is self-evident that any subsequent conversion of the instrument must take place in accordance with the original conversion right, however remote the likelihood the conversion feature would effect the settlement of the instrument at issuance. Similarly, any modification of the original conversion feature will be reflected in a change to the conversion price and is readily apparent. Consider the following example:

Example X

An entity issues a convertible bond for par in the amount of $1,000 with a maturity date of December 31, 2010. The issuer can call the bond at any time after December 31, 2008. The holder can convert the bond into five shares of the issuer's stock at any time, including upon the issuer's exercise of its call, making the conversion price $200 per share. At the bond's issuance date the issuer's stock price is $60. The coupon rate of the bond approximates the rate the issuer estimates it could obtain if it issued nonconvertible debt of an equivalent term.

The issuer's share price on January 1, 2009 is $240 and the issuer exercises its call option. The holder elects to receive five equity shares to settle the instrument. The conversion is not within the scope of this Issue nor is it within the scope of APB 26 since it clearly occurs in accordance with a conversion privilege that existed at issuance.

21. As illustrated in support of View B, opponents to View A do not believe the same assumption can be made about the ultimate conversion of a CoCo.

22. If the Task Force supports View A, the staff will ask the Task Force whether additional guidance should be provided about evaluating the substance of a conversion feature in the context of this Issue. If the Task Force believes additional guidance should be provided, the staff proposes that the guidance take the form of a definition similar to the following:

> For purposes of applying the guidance in this Issue, a substantive conversion feature is a conversion feature that is reasonably possible to affect the settlement of its host instrument.

23. If the Task Force supports View A, the staff will ask the Task Force to clarify that for purposes of this Issue, the issuance date of an instrument is the same as the instrument's commitment date under Issue 98-5 (as amended by Issue 00-27).

View B: The accounting should be determined by reference to the likelihood the conversion feature will affect the settlement of the instrument immediately prior to the date the instrument is called.

24. Proponents of View B believe that a conversion in the scope of this Issue may be in accordance with a conversion feature that existed at issuance or it may result from the issuer exercising a settlement alternative.

25. Proponents of View B believe that a "conversion feature" that becomes exercisable upon the exercise of an issuer's call option may be equivalent to a settlement alternative similar to the hypothetical instrument described in paragraph 14. They believe that the substance of such a feature must be determined by reference to the other substantive contingent conversion features in the instrument immediately prior to the call. Example Y illustrates a circumstance when the issuer's call functions as a settlement alternative because it allows conversion though the original conversion feature would not.

Example Y

An entity issues a contingently convertible bond for par in the amount of $1,000 and a maturity date of December 31, 2010. The issuer can call the bond any time after December 31, 2008. At the bond's issuance date the issuer's stock price is $70, and on conversion the bond holder will receive 10 shares of the issuer's stock. The coupon rate of the bond is 3.5 percent.

The bond may be converted at the holder's option if the market price of issuer's stock exceeds $120 for a consecutive 30-day period or if the issuer exercises it call option.

Based on an analysis of the effective annual interest rate per the terms of the CoCo relative to the estimated effective annual rate the issuer could obtain in a non-convertible instrument with an equivalent term, the issuer concludes that the conversion feature is substantive at issuance.

The issuer's share price on December 30, 2010, is $110 and the issuer exercises its call option, the bond is not otherwise currently convertible. The fair value of the CoCo immediately prior to the issuer's exercise of its call is $1,000, the value of its debt component. The discount between the conversion value of the instrument and its fair value is due to the market's conclusion that the market price trigger will not be met prior to maturity of the instrument.

26. In Example Y, proponents of View B believe the issuer’s exercise of its call represents a decision to utilize its settlement alternative and should be recognized as an extinguishment.

27. On the other hand, proponents of View B believe Example Z illustrates a circumstance in which a conversion is in accordance with a conversion feature that existed at issuance, though the issuer's call affects the timing of the settlement:

Example Z

An entity issues a contingently convertible bond for par in the amount of $1,000 and a maturity date of December 31, 2010. The issuer can call the bond for its par amount at any time after December 31, 2008. At the bond's issuance date the issuer's stock price is $70, and on conversion bond holder will receive 10 shares of the issuer's stock. The coupon rate of the bond is 3.5 percent.

The bond may be converted at the holder's option if the market price of the issuer's stock exceeds $120 for a consecutive 30-day period or if the issuer exercises its call option.

The issuer's share price exceeds $120 for 29 consecutive trading days from May 1 to May 29, 2009, and on May 29, 2009, when its share price is $140, the issuer calls the CoCo. The holder elects to convert the CoCo and receives 10 shares of common stock.

28. Proponents of View B believe that the likelihood that the market price trigger will be satisfied in Example Z indicates that conversion takes place in accordance with a conversion feature that existed at issuance. Proponents of View B support evaluating an embedded

conversion feature at the date the issuer exercises its call option in order to determine whether conversion of the instrument is in accordance with a conversion feature that existed at issuance or the issuer's settlement alternative.

29. Proponents of View B believe that if the embedded conversion feature is more likely than not to affect the settlement of the instrument immediately prior to the call date, the issuance of equity shares is in accordance with the conversion feature that existed at issuance and should not give rise to a gain or loss. Otherwise, settlement of the instrument should be recognized as an extinguishment. If applied to Examples Y and Z, View B would result in extinguishment accounting and conversion accounting respectively.

30. Opponents of View B believe the costs and complexities associated with evaluating an embedded conversion feature at the date an issuer exercises its call, exceed the incremental benefits derived.

View C: Any incremental value transferred from the issuer to an investor as a result of the issuer's exercise of its call should be recognized as an inducement.

31. Proponents of View C believe that a conversion in the scope of this Issue may represent a change to the terms of a conversion privilege that existed upon the issuance of the instrument. As explained more fully by opponents to View A, the structure of a CoCo makes determining whether the terms of an agreement have been changed more difficult because risk of non-convertibility may be embedded in the contingent conversion feature and not the conversion price of an instrument.

32. Proponents of View C believe a conversion feature should be measured immediately before and after the issuer's call is exercised. Any increase in the fair value of the embedded conversion feature resulting from the issuer's call indicates that the terms of the instrument have changed. Because the change is initiated by the issuer's call (that is, at the same time the instrument will be settled), the change in fair value should be considered an inducement and recognized as an expense at the date of the issuer's call.

33. Proponents of View C believe it is consistent with the principles of FAS 84, which requires that incremental value transferred to a holder of a debt instrument be measured and recognized as an expense if the transfer takes the form of a change to the original terms of the contract. Proponents of View C argue that when the transfer of incremental value occurs, it should be measured and recognized as an expense, regardless of the means by which it is accomplished.

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

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

35. Some proponents of View D believe that the holder receives value upon the issuer's decision to call the debt that the holder was not entitled to receive according to the terms of the instrument immediately prior to the call. They believe value transferred to the holder beyond the maximum value the holder was entitled to receive per the terms of the instrument immediately prior to the call should be recognized as an extinguishment.

Illustrative Examples

36. The following examples are provided to facilitate the Task Force's consideration of this Issue. The examples demonstrate the application of the various views set forth above to contingently convertible instruments both with and without the characteristics of Instrument C in Issue 90-19. Based on conversations with market participants, the staff believes that most CoCos issued since the Task Force's consensus on Issue 04-8 have the characteristics of Instrument C. If the Task Force reaches a consensus on this Issue, the staff will ask the Task Force whether the examples should be included in the draft abstract that will be posted for public comment.

Example 1—Contingently Convertible Debt

37. 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. The coupon rate of the bond is 3.5 percent. If the issuer calls the CoCo, the holder has 30 days to receive cash for the accreted value of the instrument or 10 shares of common stock. 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 either of the following events:

a. The market price of the issuer's stock exceeds $120 for a consecutive 30-day period
b. Consummation of a change in control of the issuer.

Example 1—Scenario #1

38. The issuer's stock price exceeds $120 for 30 consecutive trading days from May 1 to May 30, 2009, and, on May 30, 2009, when its share price is $121, the issuer calls the CoCo. On June 29, 2009, the issuer's share price is $110 and the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100.

Scope

39. Because the CoCo was convertible at the discretion of the holder immediately prior to the issuer's exercise of its call option, the conversion is not within the scope of Issue 05-1. The carrying amount of the debt is credited to equity, and no gain or loss is recognized.

Example 1—Scenario #2

40. 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. The stock price on the call date is $150 per share. The value of the CoCo immediately prior to the call is $1,500. On June 28, 2009, the stock price is $140 and the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,400.

Scope

41. This scenario is within the scope of Issue 05-1. The holder did not have the legal right to convert based on the CoCo's market price trigger prior to the issuer's exercise of its call option on May 29, 2009.

Analysis of fact pattern under View A

42. Based on an analysis of the effective annual interest rate per the terms of the CoCo relative to the effective annual rate that the issuer estimates it could have obtained on a similar non-convertible instrument of an equivalent term, the issuer concludes that, upon issuance, the embedded conversion feature is substantive (that is, it is reasonably possible that the conversion feature will affect the settlement of the instrument). As a result, the subsequent conversion of the instrument is deemed to have occurred pursuant to the instrument's original terms and no gain or loss is recognized. The carrying value of the CoCo is credited to equity.

Analysis of fact pattern under View B

43. Based on the likelihood the market price trigger will be satisfied, the issuer concludes that it is more likely than not that the conversion feature would affect the settlement of the instrument immediately prior to the call. As a result, the conversion is deemed to have occurred pursuant to a conversion privilege included in the instrument at issuance and no gain or loss is recognized.

Analysis of fact pattern under View C

44. Because the fair value of the conversion feature ($500) immediately prior to and after the call is unchanged, no change to the terms of the instrument is deemed to have occurred and no inducement expense is recognized.

Analysis of fact pattern under View D

45. The loss on extinguishment of the bond is $400, the difference between the settlement value ($1,400) and the carrying amount of the bond ($1,000).

Example 1—Scenario #3

46. As of January 1, 2024, the instrument is not convertible at the discretion of the investor, the stock price is $110 and the issuer exercises its call option. The holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100. The fair value of the CoCo immediately prior to the call is $1,045.

Scope

47. When the issuer exercised its call option on January 1, 2025, the holder did not have the legal right to convert based on the CoCo's stated contingent triggers. This scenario is within the scope of Issue 05-1 because the issuer provides the holder with the opportunity to convert, which it did not have otherwise.

Analysis of fact patterns under View A

48. Based on an analysis of the effective annual interest rate per the terms of the CoCo relative to the effective annual rate that the issuer estimates it could have obtained on a similar nonconvertible instrument of an equivalent term, the issuer concludes that, upon issuance, the embedded conversion feature is substantive (that is, it is reasonably possible that the conversion feature will affect the settlement of the instrument). As a result, the subsequent conversion of the instrument after conversion is deemed to have occurred pursuant to the instrument's original terms and no gain or loss is recognized.

Analysis under View B

49. Based on the value of the conversion feature immediately prior to the issuer's exercise of its call, the issuer concludes that it is not "more likely than not" that the conversion feature would have affected the settlement of the instrument. As a result, the issuer’s call represents the exercise of its settlement alternative and the issuance of equity shares to settle the CoCo within the scope of APB 26. The loss on extinguishment of the bond is $100, the difference between the settlement value and the carrying amount of the bond.

Analysis under View C

50. The difference ($55) between the fair value of the conversion feature immediately after the call ($100) and the fair value of the conversion feature immediately prior to the issuer's exercise of its call ($45) is incremental value transferred to the holder and indicates that the terms of the instrument have been changed as a result of the call. Fifty-five dollars is recognized as an inducement and a credit to equity. The carrying value of the debt is credited to equity.

Analysis under View D

51. Under View D, the loss on extinguishment of the bond is $100, the difference between the settlement value and the carrying amount of the bond.

Example 2—Instrument C in Issue 90-19 with a Market Price Trigger

52. Instrument C, as described in Issue 90-19, is a debt instrument, and when it is converted, the issuer must satisfy the accreted value of the obligation in cash and may satisfy the conversion spread in either cash or stock.

53. 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. 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 coupon rate of the bond is 3.5 percent.

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

a. The market price of the issuer's stock exceeds $120 for a consecutive 30-day period (market price trigger), and the bond becomes convertible at the holder's option during the subsequent calendar quarter
b. Consummation of a change in control of the issuer.

Interaction of this Issue with Issue 03-7

55. Some believe the example instrument presented is within the scope of this Issue, as currently defined, and Issue 03-7. Under certain circumstances, each of the views presented in this Issue require the recognition of an expense to the issuance of the equity shares. Some believe that recognizing an expense related to the issuance of equity shares to settle an instrument with the characteristics of Instrument C contradicts the guidance provided in Issue 03-7. Issue 03-7 requires that an extinguishment gain or loss associated with such a settlement be determined considering only the cash paid (that is, ignoring the value of the equity shares issued). If the Task Force reaches a consensus on this Issue, the FASB staff will recommend that the Task Force amend Issue 03-7 to clarify that it applies to settlements not within the scope of this Issue. The analysis presented below assumes the Task Force does not object to this recommendation.

Example 2—Scenario #1

56. The issuer's stock price exceeds $120 for 29 consecutive trading days from May 1 to May 29, 2009, and on May 29, 2009, when its stock price is $150, the issuer calls the CoCo. The holder receives $1,000 and 3.333 shares valued at $500. Assume the fair value of the CoCo immediately prior to the issuer's exercise of its call is $1,500.

Scope

57. When the issuer exercised its call option on May 29, 2009, the holder did not have the legal right to convert based on the original terms of the CoCo. Therefore, this scenario is within the scope of Issue 05-1 because the issuer provides the holder with the opportunity to convert, which it did not have immediately prior to the call.

58. Because the settlement is within the scope of Issue 05-1, it will not be in the proposed revised scope of Issue 03-7. However, accounting for the cash paid to settle an instrument within the scope of this Issue is consistent with its required treatment under Issue 03-7 (that is, it is considered in determining the gain or loss from extinguishment).

Analysis of fact pattern under View A

59. Based on an analysis of the effective annual interest rate per the terms of the CoCo relative to the estimated effective annual rate that the issuer estimates it could have obtained on a similar non-convertible instrument of an equivalent term, the issuer concludes that, upon issuance, the embedded conversion feature is substantive (that is, it is reasonably possible that the conversion feature will affect the settlement of the instrument). As a result, the subsequent conversion of the instrument is deemed to have occurred pursuant to the instrument's original terms and no gain or loss is recognized related to the issuance of equity shares. However, the gain or loss related to the cash paid to extinguish the debt should be determined in accordance with APB 26. As a result, the loss on extinguishment is $50; the difference between the cash paid of $1,000 and the carrying amount of the bond, including the remaining unamortized deferred financing costs of $50.

Analysis of fact pattern under View B

60. Based on the likelihood that the market price trigger will be satisfied immediately prior to the call date, the issuer concludes that it is more likely than not that the conversion feature would affect the settlement of the instrument immediately prior to the call. As a result, the conversion is deemed to have occurred pursuant to a conversion privilege included in the instrument at issuance and no gain or loss is recognized related to the issuance of equity shares. However, the gain or loss related to the cash paid to extinguish the debt should be determined in accordance with APB 26. As a result, the loss on extinguishment is $50; the difference between the cash paid of $1,000 and the carrying amount of the bond, including the remaining unamortized deferred financing costs of $50.

Analysis of fact pattern under View C

61. Because the fair value of the conversion feature ($500) immediately prior to and after the call is unchanged, no change to the terms of the instrument is deemed to have occurred and no inducement expense is recognized related to the issuance of equity shares to satisfy the conversion spread. However, the gain or loss related to the cash paid to extinguish the debt should be determined in accordance with APB 26. As a result, the loss on extinguishment is $50.

Analysis of fact pattern under View D

62. The loss on extinguishment of the bond is $550; the difference between the settlement value and the carrying amount of the bond, including the remaining unamortized deferred financing costs.

Earnings per share impact

63. Each of the bonds described above may become convertible based on 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 earnings per share treatment of the bonds is not impacted by this Issue.

Amendments to Issue 03-7

64. If the Task Force agrees with the FASB staff recommendation to amend the scope of Issue 03-7, the staff proposes to amend paragraph 5 of Issue 03-7 as follows (additions are underscored and deletions are struck through):

> While the Issue 90-19 consensus, as revised, provides guidance for the accounting for Instrument C at issuance, Issue 90-19 does not address the accounting at settlement for Instrument C, and questions have arisen in practice about the accounting for the excess of the conversion spread over the accreted value of the obligation at settlement. With the exception of Issue No. 05-1, "Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option", ~~C~~current accounting guidance for convertible debt (for example, Opinion 14, Opinion 26, Statement 84, and Issues No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," and No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments") also does not specifically address the settlement accounting for Instrument C of Issue 90-19. Therefore, for transactions other than those within the scope of Issue 05-1, ~~T~~this Issue addresses how the issuer should account at settlement for Instrument C in Issue 90-19 if the issuer settles the conversion spread in stock. If settled in cash, the issuer would record a gain or loss based on the total cash consideration compared with the carrying amount of the debt. This Issue assumes that the embedded conversion feature meets the criteria in paragraphs 12–32 of Issue 00-19 for classification within permanent equity. If it did not meet those criteria, this Issue would not arise because the embedded conversion feature would be bifurcated from the debt host as a separate liability and accounted for as a derivative.

65. Additionally, the staff proposes that the following statement be included in any final abstract on this Issue (Issue 05-1):

> Upon settlement of an instrument with the characteristics of Instrument C in Issue 90-19 by payment of the accreted value of the obligation in cash and settlement of the conversion spread with stock, the cash payment should be considered in the computation of gain or loss on extinguishment of the recognized liability. The treatment of the shares transferred should be determined by reference to the guidance in this Issue.

Transition

66. 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 the issue may begin to emerge since many of the CoCos that were issued in 2000 and 2001 have call options that become exercisable commencing in 2005.

67. If the Task Force reaches a consensus consistent with Views B, C, or D, the FASB staff recommends that the guidance in this Issue should be effective for all conversions within its scope that result from the exercises of call options that occur in interim periods beginning after the date the Board ratifies the consensus.

68. However, if the Task Force reaches a consensus consistent with View A, the Task Force may wish to consider how the guidance in this Issue should be applied to instruments issued prior to Board ratification if information necessary to evaluate the conversion feature as of its issuance date is not available. An alternative is to require an evaluation of the substance of the embedded conversion feature as of the beginning of the first interim period beginning after Board ratification of this Issue.

69. Early application of this Issue is permitted in periods for which financial statements have not yet been issued. Restatement of previously issued financial statements is not permitted.