

FASB Emerging Issues Task Force

Issue No. 05-7

Title: Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues

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Previously distributed EITF materials: Issue Summary No. 1, dated August 30, 2005

References:

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

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

International Accounting Standard 32, *Financial Instruments: Disclosure and Presentation* (IAS 32)

EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments" (Issue 96-19)

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

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments" (Issue 00-27)

* **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.**

Background

1. At the December 2004 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff discussed the accounting for the modification of conversion options embedded in convertible debt instruments pursuant to the analysis required by Issue 96-19 to determine whether a debt instrument had been substantially modified and accounted for as an extinguishment. In its speech, the SEC staff stated, in part:

When an issuer modifies a convertible security, the issuer must compare the fair value of the conversion option immediately following such modification with its fair value immediately prior to the modification. In using the term fair value, I am referring to both the intrinsic and time value components of the conversion option. To the extent that a difference is identified, that difference should be included in any EITF Issue 96-19 analysis in the same way as one would include a current period cash flow. An example of a current period cash flow would be any fees exchanged between the debtor and the creditor, the treatment of which is explicitly addressed in the provisions of EITF 96-19. [Footnote reference omitted.]

2. Prior to the SEC speech there were differing views on whether to include the change in the fair value of an embedded conversion option in the Issue 96-19 analysis. While the speech provided guidance on determining whether the modification results in an extinguishment of the debt instrument pursuant to the guidance in Issue 96-19, the speech also raised additional questions regarding the accounting for those types of modifications. The Issues originally brought to the Task Force included:

Issue 1—Whether the change in the fair value of an embedded conversion option that results from a modification of a convertible debt instrument should be included in the analysis of whether there has been a substantial change in the terms of a debt instrument to determine if a debt extinguishment has occurred pursuant to Issue 96-19.

Issue 2—In modifications that do not result in a debt extinguishment pursuant to Issue 96-19, whether the modification to a convertible debt instrument that changes the fair value of an embedded conversion option affects subsequent recognition of interest expense for the associated debt instrument.

Issue 3—In modifications that do not result in a debt extinguishment pursuant to Issue 96-19, whether an issuer should recognize a beneficial conversion feature or reassess an existing beneficial conversion feature if upon modification of a convertible debt

instrument, the embedded conversion option is in-the-money and the intrinsic value of the embedded conversion option has increased.

Prior Task Force Discussion

3. At the September 15, 2005 EITF meeting, the Task Force reached a consensus on Issue 1 that an entity should include, upon the modification of a convertible debt instrument, the change in fair value of the related embedded conversion option in the analysis to determine whether a debt instrument has been extinguished pursuant to Issue 96-19. The change in the fair value of an embedded conversion option should be calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification and it should be included in the Issue 96-19 analysis because there is a direct correlation between the value of an embedded conversion option and the yields demanded on a convertible debt instrument. Because Issue 96-19 focuses solely on a differential cash flow analysis in determining the occurrence of an extinguishment or modification, the Task Force agreed to amend Issue 96-19 to include non-cash changes to the conversion terms under this consensus.

4. The Task Force also reached a consensus on Issue 2 that the modification of a convertible debt instrument should affect subsequent recognition of interest expense for the associated debt instrument by the recognition of the change in the fair value of the conversion option and the recognition of any consideration paid or received as part of that modification. The change in the fair value of an embedded conversion option should be calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification. The Task Force observed that the value exchanged by the holder for the modification of the conversion option should be recognized as a discount (or premium) with a corresponding increase (or decrease) in additional paid-in capital. In reaching that conclusion, the Task Force discussed whether its consensus was inconsistent with APB 14 (which generally does not permit separate recognition of an embedded conversion option). The Task Force did not believe the consensus on Issue 2 was inconsistent with APB 14 because APB 14 only pertains to the accounting at issuance for convertible debt instruments and does not address the accounting for modifications to convertible debt instruments. In addition, the Task Force observed that the consensus reached in Issue 2 was consistent with the guidance in Issue 96-19 on accounting for

fees paid by the debtor to the creditor or received by the debtor from the creditor as part of a modification that does not result in a debt extinguishment under Issue 96-19.

5. The Task Force also reached a consensus on Issue 3 that the issuer should not recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon modification of a convertible debt instrument. The Task Force concluded that the only value associated with the modification of an embedded conversion option that should be accounted for is the change in the fair value of the embedded conversion option discussed under Issue 2.

6. At the March 16, 2006 EITF meeting, the Task Force agreed to clarify the scopes of Issue 05-7 and Issue 96-19 by adding a paragraph to the abstract to clarify that the consensus in Issue 05-7 also applies to a modification of a debt instrument that either adds or eliminates an embedded conversion option that is not bifurcated from its host contract pursuant to FAS 133. The Task Force also agreed that the scope of Issue 05-7 does not include the modification of debt instruments that either adds or eliminates an embedded conversion option that is required to be bifurcated by the issuer from the host contract pursuant to FAS 133 because the Task Force did not discuss those circumstances in its deliberations on Issue 05-7.

7. At the May 5, 2006 EITF Agenda Committee meeting, the Agenda Committee was asked to consider redeliberating certain aspects of Issue 2 due to concerns raised about the accounting for modifications that decreased the value of or that eliminated the embedded conversion option. The issue brought to the Agenda Committee included:

Whether the elimination of an embedded conversion option (or reductions in the fair value of a conversion option) should be effectively accounted for as the repurchase of equity consistent with the consensus reached in Issue 2 of Issue 05-7.

Since the Issue proposed to the Agenda Committee represents only a portion of the original Issue discussed by the Task Force at its September 15, 2005 meeting, the FASB staff believes that when the Issue is redeliberated, and if a new consensus is reached, it may be inconsistent with the original consensus for embedded conversion options that have been added to a debt

instrument or that have had their fair values increase. To address this potential inconsistency, the FASB staff believes that the Task Force should consider redeliberating the original Issue (Issue 2) and include as a separate view the Issue (and related alternative views) proposed to the Agenda Committee. In addition, the FASB staff believes that the Task Force should also consider redeliberating the consensus on Issue 3 reached at the September 15, 2005 EITF meeting since a different consensus on this Issue may impact Task Force member's views concerning the original consensus reached on Issue 3. Some FASB staff members also believe that the Task Force may need to reconsider the consensus reached at the September 15, 2005 EITF meeting on Issue 1 if the Task Force reaches a consensus other than View A for Issue 1 of this Issue Summary Supplement.

Scope

8. The scope of this Issue Summary Supplement applies to convertible instruments that are accounted for under APB 14 and related interpretations including modifications that add or eliminate an embedded conversion option and excludes from its scope those modifications that either add or eliminate an embedded conversion option that is required to be bifurcated by the issuer from the host contract pursuant to FAS 133.

Accounting Issues and Alternatives

Issue 1: Whether the modification of a convertible debt instrument that changes the fair value of an embedded conversion option affects subsequent recognition of interest expense for the associated debt instrument when the modification does not result in a debt extinguishment pursuant to Issue 96-19.

View A: The modification of a conversion option affects the subsequent recognition of interest expense for the associated debt instrument by the recognition of the change in the fair value of the conversion option and the recognition of any costs paid or received as a part of that modification. This is consistent with the original consensus in Issue 05-7.

9. Proponents of View A believe that since there is a direct correlation between the value of a conversion option and the yields demanded on the debt security and because investors evaluate

both components (that is, cash flow and non-cash flow conversion options) in making decisions, a change in the fair value of the conversion option should be treated in the same manner as changes in cash flows between the debtor and creditor consistent with the consensus in Issue 05-7 (Issue 1), which amended Issue 96-19, in determining whether an extinguishment has occurred. Issue 96-19 states, in part:

...the fees are to be associated with the replacement or modified debt instrument and, along with any existing unamortized premium or discount, amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the interest method.

10. Therefore, proponents of View A believe that the change in the fair value of the conversion option should be recognized upon the modification as a discount (or premium) associated with the debt, and the offset to the discount (or premium) would be recognized in equity since it is economically consistent with the treatment of a cash flow between a debtor and a creditor.

11. Proponents of View A also point out that any consideration paid or received that is associated with that modification would also be recognized in interest expense over the remaining term using the interest method. That consideration could include, for example, a change to the interest rate, the carrying amount, the remaining term of the debt instrument, or a payment or receipt of cash. Proponents of View A believe that both of these items should be accounted consistently since both represent a change in fair value (that is, the modification of the conversion option and the consideration paid or received for that modification).

12. Opponents to View A believe that this treatment allows entities to enjoy a favorable effective interest rate for those modifications that result in a decrease in the fair value of the conversion option or an elimination of the conversion option and, as a result, creates structuring opportunities for entities to modify their debt instruments to achieve a financial statement effect that they would not have been able to achieve without the conversion option (refer to Illustration 1). In addition, opponents to View A also point out that View A may create structuring opportunities upon modification, as it relates to the accounting for beneficial conversion features. For example, an entity could have a modification that adds an in-the-money conversion option

that reduces the face amount of the debt instrument without having to record the expense associated with the beneficial conversion feature or reflect an adjustment to the effective interest rate. Proponents of View A counter that while a beneficial conversion feature is accounted for based on its intrinsic value at issuance (not at modification), an adjustment of the interest rate has occurred resulting from the change in the fair value of the conversion option, which has been reflected inherently in the effective interest rate, based on a different valuation methodology (intrinsic value and fair value).

Illustration 1 – Cash Paid to Eliminate a Conversion Option

13. This illustration provides an example of the application of View A assuming cash is paid to eliminate an embedded conversion.

14. An entity has convertible bonds recorded at a face value of \$500 million (the face value is assumed to approximate the present value of future cash flows). At issuance, the embedded conversion option had no intrinsic value and was not required to be bifurcated and accounted for separately. As a result of the conversion option, the entity was able to issue the debt at a coupon of 5 percent (market rate without the conversion option would be 10 percent). The current fair value of the embedded conversion option is \$100 million. The entity modifies the debt instrument by eliminating the embedded conversion option and paying the holders cash equal to the fair value of the embedded conversion option at the time of modification (\$100 million). The entity performs the Issue 96-19 analysis and concludes that the 10 percent threshold (including both the change in the value of the conversion option and the cash paid to holders) has not been exceeded and, therefore, applies modification accounting. For simplicity, assume for purposes of this example that the remaining term of the bonds is 10 years and that the straight-line method approximates the effective interest method.

Accounting Entries (*in millions*)

At Modification

1	Dr. Equity	\$100	
	Cr. Debt Premium		\$100

(To record the change in the fair value of the embedded conversion option)

2	Dr. Debt Discount	\$100	
	Cr. Cash		\$100

(To record the cash paid to the holders to eliminate the conversion option pursuant to Issue 96-19)

Subsequent Annual Entries

3	Dr. Debt Premium	\$10	
	Cr. Interest Expense		\$10

(To record the amortization of the change in the fair value of the embedded conversion option (\$100 million) using the interest method)

4	Dr. Interest Expense	\$10	
	Cr. Debt Discount		\$10

(To record the amortization of the cash paid to the holders (\$100 million) using the interest method)

Illustration 2 – Addition of a Conversion Option

15. This illustration provides an example of the application of View A assuming an embedded conversion option is added to a debt instrument.

16. An entity has bonds recorded at a face value of \$700 million (the face value is assumed to approximate the present value of future cash flows) at a coupon of 10 percent. At issuance, there is no embedded conversion option. The entity modifies the debt instrument. The face value of the new debt is \$500 million and an embedded conversion option is added that has a fair value of \$200 million (which includes an in-the-money conversion option). The entity performs the Issue 96-19 analysis and concludes that the 10 percent threshold (including both the change in the value of the conversion option and the \$200 million consideration to add the conversion option) has not been exceeded and, therefore, modification accounting is applied. For simplicity, assume for purposes of this example that the remaining term of the bonds is 10 years and that the straight-line method approximates the effective interest method.

18. Proponents of this view note that APB 14 does not permit income statement recognition for a conversion option even though that conversion option provides the holder with an economic benefit (except in limited circumstances as described in paragraph 18 of APB 14, Issues 98-5 and 00-27, and FAS 133). Thus, proponents of this view believe that if the economic benefit originally provided to the holder through the conversion option is not recognized, then subsequent changes to the conversion option should also not be recognized.

19. Opponents to this view believe that View B is inconsistent with the original consensus in Issue 1, which amended Issue 96-19. That is, the change in the fair value of the embedded conversion option should be included in the analysis to determine whether there has been a substantial modification, similar to the manner in which fees are paid between a debtor and a creditor. Opponents to View B believe that to be consistent with Issue 96-19, the change in the fair value of the conversion option should also be included in the determination of the effective interest rate.

20. Proponents of View B counter that while Issue 96-19 discusses how the fees paid between a debtor and creditor are accounted for in the financial statements (for example fees paid to cancel a call option and the related effect on the effective interest rate), Issue 96-19 does not indicate how the cancellation of the related call option is to be accounted for in the financial statements. Proponents of View B argue that supporters of View A have inappropriately analogized that the cancellation of a conversion option, for example, should be accounted for in the same manner as fees paid between a debtor and a creditor. That is, View B proponents believe that the proper application of Issue 96-19 is for entities to only account for the consideration given (or received) to modify the instrument, not the item that has been adjusted (conversion option or the elimination of a debtor's call option).

21. Lastly, opponents of View B believe that if a consensus is reached on View B, the Task Force should reconsider its previous consensus on Issue 2 of this Issue Summary, which addresses upon modification, the recognition of a new beneficial conversion feature or the reassessment of an existing beneficial conversion feature.

Illustration 3 – Cash Paid to Eliminate A Conversion Option

22. Assuming the same facts as in Illustration 1, this illustration provides an example of the application of View B assuming cash is paid to eliminate an embedded conversion option.

Accounting Entries (*in millions*)

At Modification

1	Dr. Debt Discount	\$100	
	Cr. Cash		\$100

(To record the cash paid to the holders to eliminate the conversion option pursuant to Issue 96-19)

Subsequent Annual Entries

2	Dr. Interest Expense	\$10	
	Cr. Debt Discount		\$10

(To record the amortization of the cash paid to the holders (\$100 million) using the interest method).

Illustration 4

23. Assuming the same facts as in Illustration 2, this illustration provides an example of the application of View B assuming an embedded conversion option is added to a debt instrument.

Accounting Entries (*in millions*)

At Modification

1	Dr. Debt	\$200	
	Cr. Debt Premium		\$200

(To record the change in the face value of the debt instrument for the consideration received to add the conversion option)

Subsequent Annual Entries

2	Dr. Debt Premium	\$20	
	Cr. Interest Expense		\$20

(To record the amortization of the consideration received from the holders (\$200 million) using the interest method)

View C: The modification of a conversion option that changes the fair value of that option, affects the subsequent recognition of interest expense for the associated debt instrument for modifications that increase the value of the conversion option (or add a conversion option) by the recognition of the change in the fair value of the conversion option and the recognition of any consideration received as a part of that modification. The modification of a conversion option that changes the fair value of that option, affects the subsequent recognition of interest for the associated debt instrument for modifications that decrease the value of the conversion option (or eliminate the conversion option), but only for the consideration paid or received associated with the modification of the debt instrument, and not for the change in the fair value of the conversion option.

24. Proponents of View C believe that if the change in the fair value of an embedded conversion option is recorded as proposed in View A for modifications that result in a reduction in value or the elimination of a conversion option, the effect on the financial statements will result in an adjustment that essentially offsets the increase that would have otherwise occurred in the effective interest rate over the remaining term of the debt, creating structuring opportunities for entities.

25. For example, under View C if cash is paid by the issuer to eliminate an embedded conversion option the cash paid would be reflected as a reduction to interest expense over the remaining term of the debt and no entries would be recorded for the change in value of the conversion option.

26. Opponents to View C believe that it is inconsistent to have differing methodologies for modifications that increase the value of a conversion option (add a new conversion option) and modifications that decrease the value of a conversion option (or eliminate the conversion option).

View D: The modification of a conversion option that changes the fair value of that option, affects the subsequent recognition of interest expense for the associated debt instrument for modifications that increase the value of the conversion option (or add a conversion option) by the recognition of the change in the fair value of the conversion option and the recognition of

any consideration received as a part of that modification. The modification of a conversion option that changes the fair value of that option, affects the subsequent recognition of interest for the associated debt instrument for modifications that decrease the value of the conversion option (or eliminate the conversion option) and should only be recognized to the extent the expense associated with a beneficial conversion feature was recorded previously related to this debt instrument in addition to the recognition of any consideration paid or received as a part of that modification.

27. Proponents of View D believe that the conclusions reached in View C may ignore the fact that a portion of the fair value of the conversion option may have been recorded as a beneficial conversion feature upon the issuance of the debt instrument (when the conversion option had intrinsic value at the issuance date) and believe that the beneficial conversion feature should reduce the amount of the change in the value that is recognized as a debt discount and recognized in interest expense over the remaining term of the debt.

Illustration 5 – Cash Paid to Eliminate a Conversion Option

28. Assuming the same facts as in Illustration 1 and that at issuance the issuer recorded a beneficial conversion feature of \$25 million, which was expensed immediately, this illustration provides an example of the application of View D assuming cash is paid to eliminate an embedded conversion option.

Accounting Entries (*in millions*)

At Modification

1	Dr. Equity	\$25	
	Cr. Debt Premium		\$25

(To record the change in the fair value of the embedded conversion option recognized as the lesser of the existing beneficial conversion feature previously expensed by the issuer or the change in the fair value of the conversion option)

2	Dr. Debt Discount	\$100	
	Cr. Cash		\$100

(To record the cash paid to the holders to eliminate the conversion option pursuant to Issue 96-19)

Subsequent Annual Entries

3	Dr. Debt Premium	\$2.5	
	Cr. Interest Expense		\$2.5

(To record the amortization of the lesser of the existing beneficial conversion feature or the change in the fair value of the conversion option using the interest method)

4	Dr. Interest Expense	\$10	
	Cr. Debt Discount		\$10

(To record the amortization of the cash paid to the holders (\$100 million) using the interest method).

Illustration 6 – Cash Paid to Eliminate a Conversion Option

29. Assuming the same facts as in Illustration 5 except that only a portion of the \$25 million beneficial conversion feature (\$10) has been recognized as an expense at the time of the modification, this illustration provides an example of the application of View D assuming cash is paid by the issuer to eliminate an embedded conversion option.

Accounting Entries (*in millions*)

At Modification

1	Dr. Equity	\$25	
	Cr. Debt Premium/Discount		\$25

(To record the change in fair value of embedded conversion option recognized as the lesser of the existing beneficial conversion feature previously expensed or the change in the fair value of the conversion option and to remove the discount(\$15) associated with the unamortized beneficial conversion feature)

2	Dr. Debt Discount	\$100	
	Cr. Cash		\$100

(To record the cash paid to the holders to eliminate the conversion option pursuant to Issue 96-19)

Subsequent Annual Entries

3	Dr. Debt Premium	\$1	
	Cr. Interest Expense		\$1

(To record the amortization of the lesser of the existing beneficial conversion feature or the change in the fair value of the conversion option using the interest method)

4	Dr. Interest Expense	\$10	
	Cr. Debt Discount		\$10

(To record the amortization of the cash paid to the holders (\$100 million) using the interest method)

International Convergence

30. Paragraphs 28 and 29 of IAS 32 provide guidance on the accounting for compound non-derivative financial instruments and states, in part:

The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.

An entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option of the holder of an instrument of the entity.

31. Therefore, as described above, from inception under IAS 32, entities must bifurcate the equity component from the liability component and record each separately on the balance sheet. In contrast, under APB 14, entities do not recognize the equity component separately from the liability. Consequently, any consensus reached by the Task Force will not affect international convergence.

Issue 2: Whether an issuer should recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon modification if the debt does not result in extinguishment under Issue 96-19, the conversion option is in-the-money, and the intrinsic value of the conversion option has increased.

32. Issues 1 and 2 are interrelated because a beneficial conversion feature would be considered a component of the fair value of the conversion option discussed in Issue 1. Proponents of views other than View B under Issue 1 may have already considered the accounting for the beneficial conversion feature as part of the cash flow under Issue 96-19. Therefore, Issue 2 will be discussed only if a consensus is reached on View B of Issue 1.

View A: An issuer should recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon modification based on the difference between the new conversion price and the share price on the modification date (that is, the modification gives rise to a new commitment date).

33. Proponents of View A believe that the debt modification results in a new commitment date and that a beneficial conversion feature should be accounted for based on the intrinsic value on that date. Issue 00-27 defines the commitment date as:

An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

- a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.
- b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

34. Proponents of View A believe that when the conversion price is modified, the intrinsic value of the conversion option would be determined by comparing the new conversion price at the new commitment date with the fair value of the underlying stock on the commitment date rather than at the original commitment date, since the terms of the agreement have changed. To the extent that the intrinsic value is "in-the-money" at the new commitment date, a beneficial conversion feature exists and should be accounted for under Issues 98-5 and 00-27.

Illustration 7 – Recognition of Beneficial Conversion Feature – New Commitment Date

35. Assume that an 8 percent, \$300 par debt instrument with a \$20 conversion option was issued. On the original commitment date the conversion option was convertible into common stock that had a fair value of \$20. Based on those assumptions, on the original commitment date

no beneficial conversion feature would be recognized. However, now assume that the debt instrument was modified and that the modification did not result in an extinguishment. The new terms of the modified debt instrument are 7 percent; \$300 par with a \$15 conversion option. On the modification date the fair value of the common stock was \$23. Based on these additional assumptions, proponents of View A believe that a beneficial conversion feature of \$8 should be recognized and accounted for in accordance with Issues 98-5 and 00-27.

View A': An issuer should recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon modification based on the difference between the new conversion price and the share price on the original commitment date (that is, modification does not give rise to a new commitment date).

36. Proponents of View A', similar to proponents of View A, believe that a beneficial conversion feature should be recognized. Proponents of View A', however, disagree with proponents of View A about the methodology used to determine the beneficial conversion feature. Specifically, they disagree about whether the commitment date is the "original" commitment date or whether the commitment date is the date of modification.

37. Proponents of View A' observe that because a "substantive change" (more than 10 percent) in the modified instrument has not occurred when analyzed under Issue 96-19, the convertible debt instrument is not remeasured under Issue 96-19. That is, because a substantive change has not occurred, there should be no change in the commitment date as originally determined pursuant to Issues 98-5 and 00-27.

38. View A' proponents also believe that remeasuring the intrinsic value of the conversion option based on the underlying share price on the modification date would result in an inconsistent measurement basis and could result in anomalous accounting results. For example, an immaterial change in the conversion price could result in a large beneficial conversion feature merely because the issuer's share price has increased since the original commitment date (that is, the beneficial conversion feature could be significantly greater than, and would be largely unrelated to, the incremental value transferred to the convertible debt holder).

39. Proponents of View A' note that Issue 00-27 discusses the calculation of the intrinsic value when there is a contingent conversion option based on a future triggering-date event. Paragraph 10 of Issue 00-27 states:

...the intrinsic value of the adjusted conversion option should be recomputed using the commitment-date fair value of the underlying stock and the proceeds received for or allocated to the convertible instrument in the initial accounting.

40. Therefore, as described above, in a situation in which there is a contingent beneficial conversion feature, the beneficial conversion feature is recognized at the time the triggering event occurs and is measured based on the fair value of the common stock at the original commitment date. While proponents of View A' acknowledge that the above guidance relates to changes to the terms provided for in the original agreement without modification, they believe that using the original commitment date for measurement is consistent with the methodology employed in Issue 00-27, which they believe is based on the concept that the underlying share price should be measured on the same date that the convertible instrument is measured.

Illustration 8 – Recognition of a Beneficial Conversion Feature – Original Commitment Date

41. Assume that an 8 percent, \$300 par debt instrument with a \$20 conversion option was issued. On the original commitment date the conversion option was convertible into common stock that had a fair value of \$20. Based on those assumptions, on the original commitment date no beneficial conversion feature would be recognized. However, now assume that the debt instrument was modified and that the modification did not result in an extinguishment. The new terms of the modified debt instrument are 7 percent; \$300 par with a \$15 conversion option. On the modification date the fair value of the common stock was \$23. Based on these additional assumptions, proponents of View A' believe that a beneficial conversion feature of \$5 should be recognized as only an additional \$5 of intrinsic value was provided to the holder. That is, they were already entitled to the \$3 increase on stock value above the original conversion price.

View B: The issuer should not recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon modification of the conversion option of a debt instrument.

42. Proponents of View B support the view that a new commitment date has not occurred based on the principle in Issue 96-19 that the changes were not substantive enough to result in a debt extinguishment and therefore would not be substantive enough to warrant a remeasurement for purposes of determining whether a beneficial conversion feature exists. As a result, no adjustment or recognition of a new beneficial conversion feature should occur and, similarly, using the example described in View A and View A', under View B, no beneficial conversion feature would be recognized.

Interaction with Other Board Agenda Projects

43. The FASB staff notes that there is an initiative underway as part of the FASB liabilities and equity project to revisit the accounting related to conversion options and modifications to convertible debt.

Effective Date and Transition

44. At the September 15, 2005 EITF meeting, the Task Force reached a consensus that this Issue should be applied to future modifications of debt instruments beginning in the first interim or annual reporting period beginning after December 15, 2005. Early application of this guidance was permitted in periods for which financial statements had not yet been issued. The disclosures required by FAS 154 were required to be made excluding those disclosures that required the effects of retroactive application.

45. If the Task Force's redeliberation of this Issue results in a new consensus, the FASB staff recommends that the consensus be effective for the first interim or annual period beginning after the ratification of this Issue. Early application of this guidance is permitted in periods for which financial statements have not yet been issued. Accordingly, the FASB staff believes that the Task Force should consider the following two transition alternatives in the event that a new consensus is reached on this Issue:

View A: A new consensus on this Issue should be applied as a change in accounting principle and applied retrospectively to those debt instruments modified subsequent to the first interim or annual period beginning after December 15, 2005 (the original effective date of Issue 05-7). Retrospective application requires the following:

- a. The cumulative effect of the change to the new accounting principle on periods prior to those presented from the original effective date of Issue 05-7 shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented*
- b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period*
- c. Financial statements for each individual prior period presented from the original effective date of Issue 05-7 shall be adjusted to reflect the period-specific effects of applying the new accounting principle.*

46. Proponents of View A believe that retrospective application to the first interim or annual period beginning after December 15, 2005 (the original effective date of Issue 05-7) would be more useful to users since prior-period balance sheet amounts and prior-period income statement amounts from the original effective date would be restated to reflect the new consensus in this Issue allowing greater consistency and comparability among entities. Proponents of View A also believe that to apply the consensus on this Issue prospectively for new modifications following the effective date may be confusing to financial statement users since the financial statements may reflect potentially three different modification methodologies.

View B: A new consensus on this Issue should be applied prospectively for future modifications of debt instruments in reporting periods beginning after the effective date of the consensus.

47. Proponents of View B believe that the time and effort required to apply the transition guidance in View A would outweigh the benefits since the Issue has been effective for only a short period of time. Proponents of View B also acknowledge that to require retrospective treatment to the original effective date would unfairly punish entities who had structured

transactions as a result of the consensus reached by the Task Force originally. Therefore, they believe that a new consensus on this Issue should be applied prospectively.

Disclosure

48. An entity shall disclose the following in the fiscal period in which a change in accounting principle is made:

- a. The nature of and reason for the change in accounting principle.
- b. The method of applying the change, and (if the Task Force reaches a consensus on View A for transition):
 - i. A description of the prior-period information that has been retrospectively adjusted, if any.
 - ii. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.
 - iii. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.