

FASB Emerging Issues Task Force

Issue No. 04-8

Title: Accounting Issues Related to Certain Features of Contingently Convertible Debt and the Effect on Diluted Earnings per Share

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References:

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

FASB Statement No. 129, *Disclosure of Information about Capital Structure* (FAS 129)

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

FASB Staff Position No. FAS 129-1, "Disclosure Requirements under FASB Statement No. 129, *Disclosure of Information about Capital Structure*, Relating to Contingently Convertible Securities" (FSP 129-1)

APB Opinion No. 15, *Earnings per Share* (APB 15)

*** The alternative views presented in this Issue Summary 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.**

Overview of Contingent Convertible Debt Instruments

1. Contingently convertible debt instruments, commonly referred to as Co-Cos, are structured financial transactions that combine the features of contingently issuable shares with a convertible debt instrument. Co-Cos are designed to take advantage of certain provisions of FAS 128 related to the computation of diluted earnings per share (EPS). Under FAS 128, issuers of Co-Cos exclude contingently issuable shares with a market price contingency from diluted EPS until the market price contingency is met. An additional benefit of Co-Cos is that they carry a lower interest rate than conventional, nonconvertible debt and, in some structures, permit the issuer to recognize little or no interest costs. For example, some structures that are commonly referred to as No-Nos (no interest; no accretion), are based on a zero-coupon bond whose fair value at issuance is equal to, or greater than, the stated par value of the bond.

2. The Co-Co market has grown significantly since Co-Cos were first issued in 2000, and, to date, over \$100 billion in Co-Cos have been issued with over \$90 billion currently outstanding.

Introduction to Co-Cos

3. Co-Cos are contingently convertible debt instruments that generally are convertible into common shares of the issuer after the common stock price has exceeded a predetermined threshold for a specified time period (market price trigger).

4. While the terms of Co-Cos can vary based on an issuer's specific facts and circumstances, a typical Co-Co includes a contingent market price trigger that exceeds a specified conversion price or the issuer's underlying stock price by a certain percentage (usually 110 percent, 120 percent, or 130 percent) on the date of issuance. Some Co-Cos have floating market price triggers under which conversion is dependent upon the market price of the stock exceeding the conversion price by a certain percentage(s) at specified times during the life of the bond. Other Co-Cos require the market price trigger to be sustained for a specified period, for example, 20 percent above the conversion strike price for a 30-day period. In addition to the plain-vanilla Co-Co described previously, Co-Cos can take many different forms that include parity features, issuer call options, maturity features, and investor put options, some of which are described later in this Issue Summary.

5. A Co-Co usually has a conversion price that exceeds the market price of the underlying stock at its issuance date, and a market price trigger that exceeds the conversion price. For example, assume a Co-Co is issued for \$1,000 and is convertible into 10 shares of common stock. A typical relationship of the relevant prices is as follows:

- Common stock price at Co-Co's issuance date - \$80
- Implied conversion price - \$100 (\$1,000/10 shares into which the bond converts)
- "Market price trigger" permitting conversion - \$120.

The market price trigger is higher than the conversion price and, accordingly, the instrument is less likely to be converted than a conventional convertible debt instrument without the market price trigger. The issuer would not include the dilutive effect of the instrument in diluted EPS unless the market price trigger had been achieved—that is, the market price of the common stock had exceeded \$120 for the specified period. In contrast, if the instrument did not include the market price trigger, the dilutive effect of the instrument would have been included in diluted EPS on an if-converted basis from the date that the instrument was issued. As evidenced from the previous discussion, a reason for issuing a Co-Co—as opposed to issuing a noncontingently convertible debt instrument—is that a Co-Co is likely to be less dilutive in the EPS computation than conventional convertible debt instruments.

More Complex Features of Co-Cos

6. Co-Cos are often more complex than the plain-vanilla instrument discussed previously. This section describes two other common features of Co-Cos that may impact the diluted EPS computation: parity provisions and issuer call options. The FASB staff acknowledges that there are many other features not discussed in this Issue Summary (such as beneficial conversion features and contingent interest), that need to be analyzed to determine if they are embedded derivatives and, if so, whether they should be separately accounted for under FAS 133.

Parity Provisions

7. Investors seek parity provisions in part to obtain greater liquidity for their investment under conditions of market or issuer stress. The parity feature may provide investors rapid access to the stock and, hence, cash, in situations in which the security is not otherwise convertible because the market price trigger has not been attained. However, others believe that parity features may disguise market price triggers that are substantially lower than the contractually stated market price triggers.

8. A parity provision in a Co-Co permits the holder of the instrument to exercise its conversion right when specific conditions are met (the terms of conditions vary) regardless of whether the market price trigger has been met. A typical parity feature establishes a value (parity value) based on the number of shares that the instrument is convertible into multiplied by the then market price of the common stock. If the market price of the convertible instrument is less than a high percentage of the parity value, such as 98 percent, the parity feature permits the investor to convert the instrument into common shares. Accordingly, a parity feature may permit an investor to convert a Co-Co and receive a conversion premium without the common stock price reaching the market price trigger. For example, carrying forward the earlier example, if the convertible debt carried a parity feature based on 98 percent or less of the current common stock price multiplied by the number of shares that it is convertible into, and the current stock price is \$105, the parity feature likely would permit conversion as the maturity date of the debt approaches (parity value: $\$105 \times 10 \text{ shares} \times 98 \text{ percent} = \$1,029$, and the fair value of the debt will approach \$1,000 as the maturity date nears). Effectively, the Co-Co with a parity feature becomes convertible at a common share price that is less than the market price trigger.

Issuer Call Options in Co-Cos

9. Some Co-Cos are callable at the issuer's option (after a stipulated non-call period) and contain a provision that permits an investor to convert the debt to common shares in the event that the debt is called, effectively eliminating the market price trigger. Using the previous example, assume the conversion price of the Co-Co is \$100 per share and the market price trigger is \$120. Further, assume that the issuer calls the Co-Co after 5 years when the market price of the stock is \$115 per share. As a result of the call, the instrument becomes convertible

and the investor likely would convert because the embedded call option is \$15 "in the money." However, had the debt not been called, the investor would not be entitled to the "in the money" conversion benefit because the market price trigger would not have been met.

Accounting Issue and Alternatives

10. Since their creation in 2000, the impact of Co-Cos on an issuer's diluted EPS has been debated. This Issue Summary addresses the threshold question of whether a market price contingency needs to be substantive for the dilutive effects of contingently convertible instruments to be excluded from diluted EPS. The FASB staff understands that the majority of current practice requires a market price contingency to be substantive for the dilutive effects of its potential conversion to be excluded from diluted EPS before the price trigger has been met (refer to View B below). Further, the staff understands that the majority of practice believes that a 10 percent or greater difference between the conversion price and the market price trigger is substantive. Although the majority of practice appears to have evolved to a common interpretation, significant diversity in practice continues.

11. The effects on EPS of other features of Co-Cos will be addressed at a future EITF meeting. Refer to the Agenda Committee Report dated May 26, 2004, for additional details.

Issue: When the dilutive effect of contingently convertible debt (Co-Co) with a market price trigger should be included in diluted earnings per share

View A: Co-Cos are a form of contingently issuable potential common shares that should be excluded from diluted EPS until the market price trigger has been met.

12. View A proponents believe that Co-Cos are contingently issuable potential common shares as they contain both a contingent issuance attribute (market price trigger) and a potential common stock feature (conversion feature). Accordingly, proponents of View A believe Co-Cos are subject to the EPS guidance of paragraph 35 of FAS 128. Paragraph 35 of FAS 128 states:

Contingently issuable potential common shares (other than those covered by a contingent stock agreement, such as contingently issuable convertible securities) shall be included in diluted EPS as follows:

- a. An entity shall determine whether the potential common shares may be assumed to be issuable based on the conditions specified for their issuance pursuant to the contingent share provisions in paragraphs 30-34.
- b. If those potential common shares should be reflected in diluted EPS, an entity shall determine their impact on the computation of diluted EPS by following the provisions for options and warrants in paragraphs 17-25, the provisions for convertible securities in paragraphs 26-28, and the provisions for contracts that may be settled in stock or cash in paragraph 29, as appropriate. [Footnote reference omitted.]

13. Based on paragraphs 30 and 32 of FAS 128, View A proponents believe that Co-Cos should be included in diluted EPS using the if-converted method only when the market price trigger has been met. Proponents of View A observe that paragraphs 30 and 32 of FAS 128 are clear as to when to include contingently issuable shares in diluted EPS; when there is a market price trigger. Paragraph 32 states:

The number of shares contingently issuable may depend on the market price of the stock at a future date. In that case, computations of diluted EPS shall reflect the number of shares that would be issued based on the current market price at the end of the period being reported on if the effect is dilutive.

14. View A proponents also believe that FSP 129-1, which requires disclosure for contingently convertible instruments, was issued because FAS 128 does not require the dilutive effect of Co-Cos to be included in diluted dEPS when the contingency has not been met. These proponents believe that the FSP requires additional disclosures to assist equity investors in understanding the potential dilutive effect of Co-Cos and the events that could trigger that dilution.

View B: Co-Cos are a form of contingently issuable potential common shares only if the market price contingency is substantive.

15. Proponents of View B believe that a market price contingency must be substantive for the shares underlying the conversion feature to be *contingently issuable* and, therefore, excluded from diluted EPS before the market price trigger has been met. View B proponents observe that

Co-Cos with a market price trigger that is close to the stated conversion price, are economically similar to conventional convertible debt and, therefore, should not be treated differently for computing diluted EPS.

16. Proponents of View B believe that the dilutive effect of Co-Cos always should be included in dilutive EPS if the market price trigger is not substantively in excess of the conversion price (even if the market price trigger has not been met). For example, proponents of View B believe that there is a substantial economic difference between market price triggers of \$103 and \$115 when the conversion price is set at \$100, and that this economic difference should be considered in the treatment of Co-Cos for diluted EPS purposes. View B proponents believe that \$15 is a substantive contingency and, accordingly, would exclude the potential dilutive effect of the conversion from diluted EPS until the market price trigger was met. In contrast, proponents believe that the \$3 difference between the conversion price and the market price trigger is nonsubstantive and, therefore, they would include the dilutive effect in the diluted EPS computation from the date that the Co-Co was issued.

17. Most proponents of View B believe that a 10 percent difference between the market price trigger and the stated conversion price is substantive. If the Task Force reaches a consensus on View B, then the FASB staff believes that the Task Force should provide guidance on when a contingency feature is substantive.

18. Opponents of View B note that there is no requirement or consideration in FAS 128 that a contingency must be substantive for the shares to be considered potentially issuable. Therefore, View B opponents believe that requiring a contingency to be substantive would be an amendment to FAS 128. Although certain opponents agree with the underlying premise of View B that transactions with similar economics should receive similar treatment in an EPS computation, they believe that the problem is inherent in FAS 128. Accordingly, they believe that the only way to fix the problem is for the Board to amend FAS 128 to require similar EPS treatment for instruments with similar economics. Those opponents also believe that the FASB-staff-issued FSP 129-1 was an intermediary solution in response to the increasing use of Co-Cos and that the staff should thoroughly address this issue.