

**FASB Emerging Issues Task Force**

**Issue No. 05-1**

**Title:** The Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option That Otherwise Is Not Convertible or Not Currently Convertible Based on a Contingency

**Document:** Issue Summary No. 1\*

**Date prepared:** March 1, 2005

**FASB Staff:** O'Callaghan (ext. 233)/Oakley (ext. 284)

**Date previously discussed:** None

**Previously distributed EITF materials:** None

**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)

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

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

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

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

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

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. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share" (Issue 04-8)

## **Background**

1. At the September 29–30 2004 EITF meeting, a consensus was reached on Issue 04-8. The contingently convertible instruments (CoCos) addressed in Issue 04-8 also may contain an embedded call option that permits conversion of an instrument even when the instrument's market price trigger has not been met. Although this Issue was raised in the context of CoCos with market price triggers, it also extends beyond market price triggers to any situation in which a call option permits conversion of an instrument that is not otherwise convertible or currently convertible based on a contingency other than the passage of time. These call options provide the issuer with the flexibility to settle outstanding debt with cash or equity if the conversion ratio is at a premium to the par value of the debt. That is, if the issuer prefers to settle the debt in shares, it may call the debt anytime before maturity (including days before maturity) and, if the conversion ratio is at a premium to the par value of the debt, the instrument holder will elect to convert the debt to equity.

2. To illustrate the underlying issue, consider the following two examples:

### **Example 1**

An entity issues a debt instrument with a \$1,000 par amount and a maturity date of December 31, 2010. The issuer can call the debt anytime between 2005 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the par amount of the debt or a fixed number of shares. If the issuer does not call the debt, the holder does not have a conversion option and must receive cash.

### **Example 2**

An entity issues a contingently convertible debt instrument with a market price trigger, a \$1,000 par amount, and a maturity date of December 31, 2020. The debt instrument is convertible at the option of the holder if the share price of the issuer exceeds a specified amount. The issuer can call the debt anytime between 2009 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the par amount or a fixed number of shares, regardless of whether the market price trigger has been met.

## Accounting Issue and Alternatives

**Issue 1: Accounting for the conversion of an instrument that becomes convertible upon the issuer's exercise of a call option that otherwise is not convertible or not currently convertible based on a contingency other than the passage of time.**

3. APB 26 applies to all extinguishments of debt, whether early or not, except (a) troubled debt restructurings (as described in FAS 15), (b) debt that is converted to equity securities (common or preferred stock) of the debtor pursuant to conversion privileges provided in the terms of the debt at issuance, and (c) debt that is converted to equity securities when the conversion privileges are changed to induce conversion of the debt to equity (as described in FAS 84).

4. If a conversion of the debt is not pursuant to the conversion privileges in the debt terms at issuance and it is not an induced conversion under FAS 84, then an entity should account for the conversion as an extinguishment of debt under APB 26. APB 26 applies to all extinguishments of debt affected by issuance of common stock or preferred stock and requires an entity to recognize a gain or loss calculated as the difference between reacquisition price and the carrying amount of the debt.

5. If the conversion of the debt is pursuant to the conversion privileges provided in the original debt terms, AIN-APB26 acknowledges that current practice is to credit the carrying amount of the debt to equity upon conversion and recognize no gain or loss.

6. If the terms of the conversion privileges are changed by the debtor to induce conversion, FAS 84, as interpreted by Issue 02-15,<sup>1</sup> requires an entity to recognize an expense equal to the fair value of all securities and other consideration transferred in excess of the fair value of the securities issuable under the original conversion terms.

*View A: The instrument's original terms provide for the possibility that an issuer will exercise its call option and, therefore, the conversion is pursuant to the original terms of the instrument.*

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<sup>1</sup> In Issue 02-15 the Task Force reached a consensus that FAS 84 applied to all induced conversions of convertible debt regardless of the party that initiated the offer or whether the offer relates to all debt holders.

*Accordingly, the conversion of the instrument should be treated in the same manner as the conversion of a noncontingently convertible debt instrument. That is, the carrying amount of the debt should be credited to equity upon conversion and no gain or loss should be recognized.*

7. View A proponents believe that from the beginning, the issuer and the holder of the instrument mutually understand that if the call option feature that exists in the original terms of the instrument were to be exercised by the issuer, it would provide the holder with the opportunity to convert the instrument either before its maturity date or before the achievement of the instrument's contingent conversion feature (if the instrument has such a feature). The issuer and holder acknowledge that the issuer's exercise of the call option may provide the holder with the opportunity to realize benefits from the conversion that it would not otherwise be entitled to absent the exercise of the call option. The call feature is a negotiated term and an integral part of the original terms of the instrument. The original pricing of the instrument includes the call option and the other terms of the arrangement (maturity date, interest rate, conversion option, and so forth). Therefore, proponents of View A believe that the issuer has accounted for the existence of the call option and related contingent conversion option by recording the original issuance and subsequent interest charges (or dividends). Accordingly, the issuer's exercise of the call option and the holder's conversion of the instrument to equity are pursuant to the original terms of the instrument and, as such, pursuant to the conversion privileges provided in the original terms of the instrument. Because the exercise of the call option and the subsequent conversion are pursuant to the original terms of the instrument, View A proponents believe that the issuer should adhere to the guidance in AIN-APB26, that is, the carrying amount of the debt should be credited to equity upon conversion and no gain or loss should be recognized.

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

8. Proponents of View B believe that an issuer's exercise of the call option is equivalent to an induced conversion and within the scope of FAS 84 because the elimination of the contingency feature (call option) is a substantial modification to the original conversion privileges and the

issuer has transferred value to the holder that it was not previously entitled to, that is, the ability to participate in the appreciation of the underlying stock. Additionally, these proponents note that the holder only has a limited amount of time to elect the conversion option pursuant to the issuer calling the debt.

9. Under View B, the issuer of the instrument shall measure the inducement expense on the date the debt holder accepts the inducement offer and converts the instrument or enters into a binding agreement to do so. The inducement expense shall be calculated as the difference between the par amount of the debt and the fair value of the stock issued. The par amount of the debt is used to measure the expense on inducement because the holder of the debt is entitled to either the face value of the debt (pursuant to the original terms of the instrument) or the fair value of the stock when the issuer exercises its call option. There is no expense recognized for the differential between the par amount and the carrying amount of the debt.

10. Proponents of View B also believe that the exercise of an issuer call option during a period in which the debt holder is not entitled to conversion is a modification of the original debt terms even though that call feature is embedded within the debt instrument at the date of issuance. These proponents believe that the terms of the call feature that alter the conversion privileges is an inducement.

11. Proponents of View B acknowledge that a strict reading of paragraph 2 of FAS 84 may lead to the conclusion that this Issue is outside the scope of FAS 84. However, proponents of View B believe that paragraph 29 provides for a broader application of the Statement. Paragraph 29 of FAS 84 indicates that the Board was aware that some convertible debt instruments include provisions permitting the issuer to alter the terms of the debt to the benefit of debt holders and that the Board concluded that conversions made pursuant to amended or altered conversion privileges, even though they are literally "provided in the terms of the debt at issuance," should be included within the scope of FAS 84. The Board concluded that the substantive nature of the transaction should govern.

12. Opponents to View B believe that this Issue is outside the scope of FAS 84 because (a) the original terms of the instrument have not been changed and (b) if the terms of the instrument were deemed to be changed, they would be outside the scope of FAS 84 because the application of FAS 84 is limited only to conversions that occur pursuant to changed terms, as narrowly described in FAS 84, that are exercisable only for a limited period of time (consistent with the call provisions) and include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance.

13. The phrase *changed terms* in FAS 84 is limited to circumstances that involve the reduction of the original conversion price, which results in the issuance of additional shares, the issuance of warrants or other securities not provided for in the original conversion terms, or the payment of cash or other consideration to those debt holders during the specified time period. Opponents of View B believe that the exercise of the call option by the issuer does not fall within the meaning of the phrase *changed terms* because nothing of value is given to the holder to induce conversion. They believe that the value of the call option was negotiated as part of the original terms of the instrument and included in the pricing of the instrument, and that the issuer is exercising its right to call the debt early and its only obligation is to notify the holder of the call.

*View B<sup>1</sup>: The exercise of the call option changes the conversion privileges of the instrument and provides an inducement for the holder to convert. Accordingly, the conversion should be recognized as an induced conversion under FAS 84. However, the measurement of the inducement expense differs from that under View B.*

14. Proponents of View B<sup>1</sup> agree with View B supporters that the exercise of the call option by an issuer is equivalent to an induced conversion and is within the scope of FAS 84. However, View B<sup>1</sup> proponents disagree with View B supporters over the application of FAS 84 in measuring the loss on the induced conversion.

15. Proponents of View B<sup>1</sup> believe that FAS 84 is strictly a fair value measurement model that requires the use of the fair value of the securities that are issuable pursuant to the original conversion terms to measure the inducement expense. Under View B<sup>1</sup>, the issuer would use the

fair value of debt before the debt is called to measure the inducement expense because no securities will be issued unless the issuer exercises its call option. Therefore, under View B<sup>1</sup> the issuer of the instrument shall measure the expense on the date the debt holder accepts the inducement offer and converts the instrument or enters into a binding agreement to do so as the difference between the fair value of the stock issued and the fair value of the debt before the call is exercised.

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

16. Proponents of View C acknowledge that the call option is provided for in the original terms of the instrument but believe that since the call option is within the control of the issuer, exercise of the call option effectively changes the conversion privileges of that instrument. They also believe that exercising the call option does not meet the requirements of an induced conversion in FAS 84. These proponents believe that because the instrument was not otherwise convertible by the holder, the exercise of the call option is a reacquisition of the instrument by the issuer and should be recognized as an early extinguishment of debt under APB 26 and TB 80-1.

17. Under View C, the issuer of the instrument shall measure the gain or loss on the date the holder converts the instrument. The gain or loss shall be calculated as the difference between the carrying amount of the debt and the fair value of the stock issued.

### **Transition**

18. It is not expected that a consensus on this Issue will result in a significant change, if any, in practice because practitioners, as well as members of the EITF Agenda Committee, have informed the FASB staff that they have not seen such conversions in practice. However, both groups believe it will be a 2005 issue that will need to be addressed because many of the CoCos that were issued in 2000 and 2001 have call options that become exercisable commencing in 2005.

19. The FASB staff's recommendation is that the transition guidance in this Issue shall be effective for periods beginning after Board ratification of the consensus and shall apply to all conversions of instruments that otherwise are not convertible or not currently convertible based on a contingency. Early application of this guidance is permitted in periods for which financial statements have not yet been issued. Restatement of previously issued financial statements is not permitted.

## Exhibit 05-01A

### EXAMPLES OF THE APPLICATION OF THE DIFFERENT VIEWS IN ISSUE 05-1

The following example illustrates the application of the different views presented in this Issue.

#### Example

On January 1, 2005, an entity issues a debt instrument with a call option with the following terms:

Par amount	\$1,000
Discount at date issuance	\$100
Stock price at date of issuance	\$50
Par value of stock	\$1
Stock price in 2015	\$60
Maturity date	2025

Additionally, if the issuer of the debt exercises its call option before 2025, the debt holder has the option of receiving 20 shares or the par amount of the debt. If the issuer does not call the debt, the holder does not have a conversion option and will receive cash at maturity.

On December 31, 2015, the issuer exercises its call option when the carrying amount of its debt is assumed to be \$950, the fair value of debt is \$970, and its stock price is trading at \$60. The holder of the debt elects to receive the shares because the fair value of the shares is \$1,200 compared to the par amount of the debt of \$1,000.

Under View A, the carrying amount of the debt is credited to equity upon conversion and no gain or loss is recognized. Using the fact pattern above, debt is debited for \$950, common stock is credited for \$20, and additional paid in capital is credited for \$930.

Under View B, induced conversion, the carrying amount of the debt is debited for \$950, conversion expense of \$200 (the fair value of the stock, \$1,200, less the par amount of the debt, \$1,000) is recognized, common stock is credited for \$20, and additional paid in capital is credited for \$1,130.

Under View B<sup>1</sup>, the carrying amount of the debt is debited for \$950, the conversion expense is \$230 (the fair value of the stock, \$1,200, less the fair value of the debt, \$970), common stock is credited for \$20, and additional paid in capital is credited for \$1,160.

Under View C, the conversion is considered a debt extinguishment and an extinguishment loss of \$250 is calculated as the difference between the carrying amount of the debt (\$950) and the fair value of the stock issued (\$1,200). Using the fact pattern above, debt is debited for \$950, an extinguishment loss is debited for \$250, common stock is credited for \$20, and additional paid in capital is credited for \$1,180.