

**FASB Emerging Issues Task Force**

**Issue No.** 05-2

**Title:** 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"

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

**Date prepared:** May 13, 2005

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**Date previously discussed:** None

**Previously distributed EITF materials:** None

**References:**

FASB Statement No. 123(R), *Share-Based Payment* (FAS 123(R))

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

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

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

APB Opinion No. 20, *Accounting Changes* (APB 20)

Statement 133 Implementation Issues No. K5, *Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues* (Implementation Issue K5)

SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"* (ASR 268)

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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. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion" (Issue 90-19)

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" (Issue 00-19)

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

## Background

1. Paragraph 12 of FAS 133 provides guidance on the bifurcation of embedded derivatives within a host contract (for example bonds, insurance policies, and leases) that do not meet the definition of a derivative in its entirety. Specifically, subparagraph 12(c) of FAS 133 indicates that one of the three necessary criteria for bifurcation is that "a separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement."<sup>1</sup>
2. Paragraph 11 of FAS 133 provides guidance on certain contracts that should not be considered and accounted for as derivative instruments for purposes of the Statement. Specifically, subparagraph 11(a) of FAS 133 indicates that "contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position" should not be considered derivative instruments.
3. Issue 00-19 provides additional guidance (specifically, paragraphs 12–32) in determining whether an embedded derivative should be considered as classified in stockholders' equity on a standalone basis in accordance with subparagraph 11(a) of FAS 133. During its deliberations of Issue 00-19, the Task Force decided to include, in paragraph 4, an exception for a "conventional convertible debt instrument" in the requirement to evaluate the embedded conversion option for compliance with paragraphs 12–32, as follows:

The Task Force observed that, pursuant to paragraphs 11(a) and 12(c) of Statement 133, if an embedded derivative is indexed to the reporting entity's own stock and would be classified in stockholders' equity if it was a freestanding derivative, that embedded derivative is not considered a derivative for purposes of Statement 133. The Task Force reached a consensus that for purposes of evaluating under Statement 133 whether an embedded derivative indexed to a company's own stock would be classified in stockholders' equity if freestanding, the requirements of paragraphs 12–32 of this Issue do not apply if the hybrid contract is a **conventional convertible debt instrument** in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount

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<sup>1</sup> The other two criteria in FAS 133 are (a) the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics of the host contract and (b) the contract that embodies both the embedded derivative and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

of cash (at the discretion of the issuer). However, the Task Force observed that the requirements of paragraphs 12–32 of this Issue do apply when an issuer is evaluating whether any other embedded derivative instrument is an equity instrument and thereby excluded from the scope of Statement 133. [Emphasis added.]

4. Constituents have indicated that the variety of contractual terms included in convertible debt instruments has increased dramatically since the Task Force deliberated Issue 00-19. These contractual terms include, but are not limited to, contingent conversion features (including single or multiple triggers, variable conversion ratios, call options, and so forth) Since the term "conventional convertible debt" is not defined in enough detail to apply to these complex structures, there is diversity in practice in evaluating whether these features are considered "conventional" for purposes of determining whether the instrument qualifies for the exception outlined in paragraph 4 of Issue 00-19. Specifically, questions have arisen as to (a) whether the nature and timing of the conversion option should impact the assessment of "conventional" and (b) how convertible instruments should be evaluated in determining whether the all of proceeds to be received upon conversion are "fixed."

5. A similar practice issue exists in evaluating whether convertible preferred stock with debt-like features (such as, convertible preferred stock with a mandatory redemption date) qualifies for the consideration under this exception. In accordance with paragraph A9 of FAS 150, convertible preferred stock with a mandatory redemption date would generally not be classified as a liability since the redemption is contingent upon the holder's not exercising its option to convert into a fixed number of shares (if conversion was into a variable number of shares, the instrument could be a liability in accordance with FAS 150). For these instruments, SEC registrants are required to follow the guidance in ASR 268. ASR 268 indicates that it does not answer "the conceptual question of whether such a security is a liability," rather it is intended to "highlight the redemption obligation and the fact that amounts attributable to these securities are not part of permanent capital." Accordingly, these instruments are classified on the balance sheet between liabilities and permanent equity in a caption commonly referred to as "mezzanine" or "temporary" equity. Due to this classification on the balance sheet, diversity in practice has developed in evaluating these instruments under the exception for "conventional convertible debt instruments" in paragraph 4 of Issue 00-19.

## Accounting Issues and Alternatives

### **Issue 1: Whether the exception to the requirements of paragraphs 12–32 of Issue 00-19 for "conventional convertible debt instruments" should be removed or further clarified.**

*View A: The exception for "conventional convertible debt instruments" should be removed from Issue 00-19.*

6. Proponents of View A believe that the exception for "conventional convertible debt instruments" should be removed from Issue 00-19. They believe that the inclusion of this exception in Issue 00-19 is inconsistent with the Board's stated intent for bifurcating embedded derivatives from their host contract. Proponents refer to paragraph 293 of FAS 133, which states, in part:

The Board considers it important that an entity not be able to avoid the recognition and measurement requirements of this Statement merely by embedding a derivative instrument in a nonderivative financial instrument or other contract. Therefore, certain embedded derivatives are included in the scope of this Statement if they would be subject to the Statement on a freestanding basis.

7. Proponents believe that the characteristics of these instruments are not unique when compared to other instruments that are not within the scope of this exception. For example, although a free-standing warrant is similar economically to an embedded conversion option within a debt instrument, only the warrant would be subject to all of the requirements of the Issue 00-19 Model. Therefore, this situation results in accounting treatment that differs merely because an instrument is embedded within a host contract.

8. Additionally, proponents of View A note that this exception was originally included in the Task Force's deliberations of Issue 00-19 at the suggestion of several Task Force members who were uncertain about whether the Task Force fully understood the ramifications of the proposed guidance on convertible debt instruments. In the absence of an understanding of the ramifications on convertible debt and the interaction with the guidance in APB 14, the Task Force agreed to include the exception. Accordingly, proponents believe that the practice issues

highlighted by constituents (as outlined in this Issue Summary) are an indication that the exception is not only unnecessary, but also not operational.

9. If the Task Force reaches a View A consensus for Issue 1, it would not need to discuss the remaining issues in the Issue Summary.

*View B: The exception to the requirements of paragraphs 12–32 of Issue 00-19 for "conventional convertible debt instruments" should be retained and additional guidance should be developed for instruments that are intended to qualify for this exception.*

10. Proponents of View B acknowledge the argument of View A proponents that the exception results in instruments with similar economic characteristics receiving different accounting treatment. However, proponents believe that the exception should not be removed from Issue 00-19 since the Task Force explicitly included this provision in recognition of the significant impact in practice this guidance would have on issuers of conventional convertible debt instruments.

11. For example, conventional convertible debt instruments may contain a provision that requires the delivery of registered shares. In accordance with paragraphs 14–18 of Issue 00-19, a requirement to deliver registered shares is deemed to be outside the control of the issuer and, therefore, it is assumed that the company will be required to net-cash settle the contract. Some proponents believe that in this situation, absent the exception in paragraph 4, the conversion option would be bifurcated from the host contract and recognized as a liability. These proponents note that in practice these contracts are rarely, if ever, net-cash settled and companies almost exclusively deliver registered shares upon conversion. Accordingly, proponents believe that the Task Force contemplated the specific characteristics of conventional convertible debt in creating the exception and to remove this language would create an accounting consequence that is inconsistent with the underlying economics of the instrument

12. Other proponents, however, refer to the guidance in paragraph 12 of APB 14, which states that "no portion of the proceeds from the issuance of the types of convertible debt securities described in paragraph 3 should be accounted for as attributable to the conversion feature."

Accordingly, they believe that no amount should be bifurcated and attributed to the conversion option. Proponents believe that the exception was included in Issue 00-19 by the Task Force partially to avoid the inconsistency that would have developed between the guidance in Issue 00-19 (without the scope exception) and APB 14. They believe that removing this exception would create an inconsistency in the GAAP literature that the Task Force was attempting to avoid.

13. Proponents of View B acknowledge, however, that practice issues have arisen in evaluating the Task Force's intent related to the types of instruments that would be considered "conventional convertible debt." Accordingly, if the Task Force decides to retain the exception, proponents believe Issue 2 and Issue 3, which follow, should be addressed.

**Issue 2: Whether a contingency related to the exercise of the conversion option should impact the assessment of whether an instrument is "conventional"<sup>2</sup> for evaluating the exception in paragraph 4 of Issue 00-19.**

*View A: Only instruments that contain an option to convert into a fixed<sup>3</sup> number of shares and the ability to exercise that option is based solely on the passage of time should be considered "conventional."*

14. Proponents of View A believe that the language in paragraph 4 implies that the Task Force intended that the exception for conventional convertible debt instruments should be very narrow (that is, apply to only "plain vanilla" convertible debt instruments) and not available to a broad range of more complex convertible debt instruments that currently are in the marketplace. They believe the Task Force did not intend for highly structured instruments, such as the contingently convertible debt (that is, CoCo's) described in Issue 04-8, to qualify for the exception.

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<sup>2</sup> The FASB staff believes that instruments that are convertible into a variable number of shares (for example, shares underlying a conversion option that is indexed to market prices, convertible variable rate debt with interest that is paid in kind, and conversion features that are indexed to an entity's credit risk) would not be considered "conventional." Further, these instruments would need to be evaluated under FAS 150.

<sup>3</sup> The FASB staff believes that an instrument with "standard" anti-dilution provisions would be consistent with the notion of converting into a fixed number of shares. In assessing whether an anti-dilution provision is "standard," the staff believes that an entity should consider the definition of an equity restructuring in the Glossary of FAS 123(R). This guidance defines an equity restructuring as "a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend."

Additionally, proponents believe that the contingent nature of CoCo's, or other instruments with conversion features that are contingent on factors other than the passage of time, results in a situation in which the number of shares is not fixed (that is, the contingent feature results in proceeds of zero shares if the contingency is not satisfied and in the stated amount in the contract if the contingency is satisfied) and, therefore, this criterion for the exception in paragraph 4 is not met.

*View B: Instruments that provide the holder with an option to convert into a fixed number of shares<sup>2</sup>, and the ability to exercise that option is based on the passage of time or a contingent event, should be considered "conventional."*

15. Proponents of View B believe that the Task Force essentially defined "conventional" in paragraph 4 of Issue 00-19 as instruments "in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer)." That is, as long as the settlement of the instrument is consistent with that phrase, it should be considered "conventional convertible debt," regardless of certain other features inherent in the instrument. For example, proponents of this view believe that an instrument such as Instrument C in Issue 90-19 would not satisfy this condition since upon settlement the holder may realize the value of the conversion option in a combination of cash and shares.

16. However, proponents believe that with regard to instruments that are contingently convertible (for example, CoCo's), the contingency would not be relevant in determining whether the instrument is "conventional." Rather, they would only consider the ultimate form of settlement. That is, if upon resolution of the contingency the instrument is convertible into a fixed number of shares, the instrument is no different than a non-contingent convertible instrument in regards to the form of settlement. The notion that the two instruments are similar economically is supported by paragraph 4 of Issue 04-8, which states:

The Task Force observed that there is no substantive economic difference between contingently convertible instruments and conventional convertible instruments with a market price conversion premium. Accordingly, the Task

Force concluded that the treatment for diluted EPS should not differ because of a contingent market price trigger.

**Issue 3: Whether convertible preferred stock with a mandatory redemption date<sup>4</sup> can qualify for the exception included in paragraph 4 of Issue 00-19.<sup>5</sup>**

*View A: Convertible preferred stock with a mandatory redemption date cannot qualify for the exception included in paragraph 4 of Issue 00-19.*

17. Proponents of this view believe that the Task Force explicitly included the term "debt" in assessing whether an instrument is "conventional convertible debt" for purposes of evaluating the exception in paragraph 4 of Issue 00-19. They note that Issue 00-19 includes two references to preferred stock, and, therefore, they believe that the Task Force carefully selected the terminology used in the exception. Additionally, proponents believe that there are substantive economic differences between debt and preferred stock with a mandatory redemption date. For example, default on the payment of debt coupons is considered a default for which the lender can theoretically force a company into bankruptcy in order to receive payment. Conversely, failure to pay dividends in connection with a preferred instrument is technically not a default and recourse by the holder of the instrument is typically limited to a restriction of dividends that can be paid to common shareholders.

18. Under the guidance of ASR 268, convertible preferred stock with a mandatory redemption date is classified by public registrants<sup>6</sup> on the balance sheet as mezzanine or temporary equity. Proponents believe that an instrument that is not classified as a liability on the balance sheet

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<sup>4</sup> For purposes of this Issue, "convertible preferred stock with a mandatory redemption date" represents an instrument that is issued in the form of preferred shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur and is convertible into common shares of the issuer at the holder's option.

<sup>5</sup> This issue applies only to the assessment of whether the instrument qualifies for evaluation of the exception in paragraph 4 of Issue 00-19 and is not intended to provide guidance on the determination of the classification of the host contract for purposes of accounting under FAS 133.

<sup>6</sup> While the guidance in ASR 268 applies to public registrants, the FASB staff believes that any consensus that is reached on Issue 4 should apply equally to both public registrants and private entities.

should not be considered debt for purposes of this evaluation. Opponents counter that the SEC explicitly indicated in ASR 268 that the guidance is not intended to answer "the conceptual question of whether such a security is a liability." Therefore, they do not believe that the classification of the instrument in the balance sheet should be determinative as to whether these instruments can qualify for the exception in paragraph 4 of Issue 00-19.

19. Proponents also note that private entities are not subject to the requirements of ASR 268 and, accordingly, generally would classify these instruments as a component of permanent equity. They believe that this is further support that convertible preferred stock with a mandatory redemption date should not qualify for the exception. Opponents counter by reiterating their view that the classification of the instrument in the balance sheet should not be determinative as to whether these instruments can qualify for the exception in paragraph 4 of Issue 00-19

*View B: Convertible preferred stock with a mandatory redemption date may qualify for the exception included in paragraph 4 of Issue 00-19 depending on whether the instrument is more akin to debt or to equity.*

20. Proponents of View B disagree with proponents of View A and believe that debt and convertible preferred stock with a mandatory redemption date have similar economic characteristics. For example, proponents of View B note that these instruments typically have terms that are similar to the terms of debt instruments, such as stated interest rates, stated maturity dates (that is, mandatory redemption date), and priority liens on assets as compared to common shareholders.

21. Additionally, proponents do not believe that the balance sheet classification of an instrument should be determinative for purposes of evaluating whether an instrument qualifies for the exception included in paragraph 4 of Issue 00-19. They believe an entity should consider the guidance in paragraph 61(l) of FAS 133, to determine whether convertible preferred stock is more akin to debt or to equity. Paragraph 61(l) states:

*Convertible preferred stock.* Because the changes in fair value of an equity interest and interest rates on a debt instrument are not clearly and closely related, the terms of the preferred stock (other than the conversion option) must be analyzed to determine whether the preferred stock (and thus the potential host contract) is more akin to an equity instrument or a debt instrument. A typical cumulative fixed-rate preferred stock that has a mandatory redemption feature is more akin to debt, whereas cumulative participating perpetual preferred stock is more akin to an equity instrument.

## **Transition**

22. As indicated above, diversity in practice currently exists for evaluating whether various convertible financial instruments qualify for the scope exception in paragraph 4 of Issue 00-19. Therefore, reaching a consensus on the issues herein will likely result in a significant change in accounting and financial reporting for certain entities. Accordingly, the FASB staff believes that the Task Force should consider transition alternatives for any consensus reached on these issues. The staff has identified the following transition alternatives.

*View A: The guidance in this consensus shall be effective prospectively for all new instruments and modifications to existing instruments entered into after the consensus is ratified.*

*View B: The guidance in this consensus shall be effective for fiscal years beginning after the date that the consensus are ratified. Consistent with transition on other FAS 133 implementation issues (as detailed in Implementation Issue K5), an entity should follow the transition provisions originally included in FAS 133. Accordingly, the effects of initially applying the guidance to existing instruments at the effective date should be reported as a change in accounting principle in accordance with APB 20. Paragraph 51 of FAS 133 provides the following additional transition guidance for a derivative that must be separated from its host contract in conjunction with the application of the consensus:*

If an embedded derivative instrument is to be separated from its host contract in conjunction with the initial application of this Statement, the entity shall consider the following in determining the related transition adjustment:

- a. The carrying amount of the host contract at the date of initial application shall be based on its fair value on the date that the hybrid instrument was issued or acquired by the entity and shall reflect appropriate adjustments for subsequent activity, such as subsequent cash receipts or payments and the amortization of any premium or discount on the host contract arising from the separation of the embedded derivative.
- b. The carrying amount of the embedded derivative instrument at the date of initial application shall be its fair value.
- c. The transition adjustment shall be the difference at the date of initial application between (1) the previous carrying amount of the hybrid instrument and (2) the sum of the new net carrying amount of the host contract and the fair value of the embedded derivative instrument. The entity shall not retroactively designate a hedging relationship that could have been made had the embedded derivative instrument initially been accounted for separate from the host contract.

*If under any consensus reached herein an entity did not account separately for an embedded derivative that has been separately accounted for under the entity's application of FAS 133 and Issue 00-19, the carrying amount of the related hybrid instrument at the guidance's effective date should be the sum of the carrying amount of the host contract and the fair value of the embedded derivative in accordance with Implementation Issue K5.*

*View C: The guidance in this consensus shall be effective for fiscal years beginning after the date that the consensus are ratified and prior periods should be restated. In determining the amount of restatement, the mechanics detailed in View B should be followed.*

## **Disclosure**

23. The FASB staff does not believe that any incremental disclosures resulting from any consensus reached by the Task Force should be required.