

FASB Emerging Issues Task Force

Issue No. 05-7

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

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References:

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

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

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 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. When an issuer modifies previously issued convertible debt, 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 to determine whether a substantial modification had occurred.

2. At the December 2004 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff discussed the accounting for the modification of conversion options in convertible debt securities as it relates to Issue 96-19, and 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.]

3. While the speech provided guidance on determining whether the modification results in an extinguishment of the debt security pursuant to the guidance in Issue 96-19, additional questions have been raised regarding the accounting for those types of modifications. The questions originally brought to the EITF Agenda Committee included:

- a. Does the modification to a conversion option that changes the fair value of that option affect subsequent recognition of interest expense for the associated debt instrument?
- b. Should an issuer recognize a beneficial conversion feature or reassess an existing beneficial conversion feature if upon modification¹ the conversion option is in-the-money and the intrinsic value of the conversion option has increased?

4. In addition to the two questions raised above, the FASB staff requests that the Task Force consider whether the change in the fair value of an embedded conversion option should be

¹ That does not result in extinguishment accounting under Issue 96-19.

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 in accordance with Issue 96-19.

Scope

5. The scope of this Issue Summary applies to convertible securities that are accounted for under APB 14 and related interpretations.

Accounting Issues and Alternatives

Issue 1: Whether the change in the fair value of an embedded conversion option upon modification 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 in accordance with Issue 96-19.

6. The purpose of Issue 96-19 is to determine upon modification of a debt instrument, if a substantial change in the terms has occurred and whether a debt extinguishment should be recognized as a result. The consensus reached by the Task Force in Issue 96-19 is that a modification of a debt instrument is considered to be substantially different (and should be considered extinguished) if the present value of the cash flows between the debtor and a creditor has changed by at least 10 percent. Cash flows can be affected by changes in principal amounts, interest rates, or maturity or fees exchanged between the debtor and the creditor to effect changes in certain features of the debt.

View A: The change in fair value of a conversion option upon modification should be included in the analysis to determine whether a debt instrument has been extinguished in accordance with Issue 96-19.

7. Proponents of View A believe that there is a direct correlation between the value of a conversion option and the yields demanded on the debt security. For example, investors typically will accept a reduced yield on a convertible debt security in exchange for a conversion option that has a fair value based on time value. Therefore, because investors evaluate both components (i.e., cash flow and non-cash flow conversion options) in making decisions, a

change in the conversion option should be considered in the Issue 96-19 analysis. Proponents of View A also believe that while Issue 96-19 is silent as to whether or how changes in the conversion option should be incorporated, it would be an incomplete analysis to exclude the change in the embedded conversion option. This analysis should include any direct changes affecting the conversion feature in addition to any fees that were paid to the investors to facilitate the modifications. Direct changes may affect either the intrinsic value or the time value of the conversion feature and may include changes that were made to the conversion price, changes in the number of shares underlying the instrument, changes in the nature of the contingencies, and changes in the debt's maturity date. Proponents of View A believe that if a change in fair value is identified, that change should be included in the same manner as current-period cash flow for determining whether an extinguishment has occurred in accordance with Issue 96-19.

View B: The change in fair value of a conversion option upon modification should not be included in the analysis to determine whether a debt instrument has been extinguished in accordance with Issue 96-19.

8. Proponents of View B believe that Issue 96-19 explicitly contemplated that an actual "cash flow" be used in determining whether a substantive change has occurred in order to trigger a debt extinguishment. Proponents of View B note that the change in the fair value of a conversion option does not represent a change in actual cash flow. Therefore, proponents of View B believe that changes in the fair value of a conversion option do not affect the cash flows of a debt instrument and should not be considered when performing an Issue 96-19 analysis of whether a substantial modification has occurred.

International Convergence

9. Currently, paragraphs 40 and AG62 of IAS 39 provide guidance on how to determine whether an extinguishment has occurred and state, in part:

An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability

or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original liability and the recognition of a new liability.

For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

10. Therefore, to determine whether a debt instrument has been substantially modified, a discounted cash flow analysis is prepared to determine whether it has changed by more than 10 percent. While conceptually this is similar to the guidance provided by U.S. GAAP, because IAS requires bifurcation of the liability and equity component of the debt instrument at inception, which differs from the accounting required under U.S. GAAP in APB 14, the accounting model under IAS 39 calculates a discounted cash flow model on the liability which excludes the change in value of the equity component. Therefore the model used under IAS is not comparable to the model used under Issue 96-19.

Issue 2: Whether the modification to a conversion option that changes the fair value of that option affects subsequent recognition of interest expense for the associated debt instrument.

View A: The modification of a conversion option that changes the fair value of that option affects subsequent recognition of interest expense for the associated debt instrument.

11. 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 (i.e., 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. Issue 96-19 indicates:

...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.

12. 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.

View B: The modification of a conversion option does not affect subsequent recognition of interest expense for the associated debt instrument for changes in the fair value of this option.

13. Proponents of View B believe a modification to a conversion option should affect only the cash flow analysis for purposes of determining whether a debt extinguishment occurred in accordance with Issue 96-19. That is, changes in the fair value of the conversion option should be included only as a current-period cash flow in the 10 percent test required by Issue 96-19. View B proponents do not believe that a change in the fair value of a conversion option should be recognized in the financial statements in the same manner as fees paid or received from the creditor.

14. 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.

International Convergence

15. Paragraphs 28 and 29 of IAS 32 provide guidance on the accounting for compound non derivative financial instruments and state, 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.

16. 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. As a result, View A would align more closely with IAS 32, but be inconsistent with the original accounting under APB 14 as described in View B.

Issue 3: 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.

17. Issues 2 and 3 are interrelated because a beneficial conversion feature would be considered a component of the fair value of the conversion option discussed in Issue 2. Proponents of View A under Issue 2 may have already considered the accounting for the beneficial conversion feature as part of the cash flow under Issue 96-19.

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).

18. Proponents of View A support the view that the modified debt results in an "in-the-money" embedded beneficial conversion feature based on the intrinsic value on the modification date since a new commitment date has been established. The intrinsic value as defined in Issue 98-5 is the difference between the conversion price and the fair value of the common stock. Proponents of View A believe that the intrinsic value should be calculated as of the date of the modification.

19. In addition, proponents of View A believe that a new commitment date has been established as a result of the modification. The commitment date is defined in Issue 00-27 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.

20. Therefore, 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 this example, on the original commitment date no beneficial conversion feature would be recognized. However, 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 this example, proponents of View A believe that a beneficial conversion feature of \$8 should be recognized.

21. 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 modification date with the fair value of the underlying stock on the modification 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 modification date, a beneficial conversion feature exists and should be accounted for under 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).

22. 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.

23. 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.

24. 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).

25. Therefore, using the same example in View A, 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 this example, on the original commitment date no beneficial conversion feature would be recognized. However, 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 this example, proponents of View A' believe that a beneficial conversion feature of \$5 should be recognized.

26. 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.

27. 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.

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.

28. 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 A and A', under View B, no beneficial conversion feature would be recognized.

International Convergence

29. Similar to the discussion in paragraphs 15 and 16 under Issue 2, IAS 32 requires that conversion options embedded in convertible debt securities be bifurcated at the time of the original issuance of the debt instrument and be accounted for separately. Paragraph AG35 of IAS 32 states:

An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognized as a loss in profit or loss.

30. Therefore, based on paragraph AG35 and example IE46 of IAS 32, a modification that increases the number of shares because of a reduction in the conversion price is recognized as a loss in the income statement based on the fair value of the underlying stock of the entity on the date of modification. The loss is calculated as the incremental shares multiplied by the share price on the modification date. Therefore, as discussed in Issue 3, View A is more closely aligned with the guidance required by IAS 32 in using the modification date to determine the new beneficial conversion feature.

Interaction with Other Board Agenda Projects

31. 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.

Transition and Disclosure

32. The FASB staff's recommendation is that the consensus on these Issues should be effective for periods beginning after December 15, 2005. Early application of this guidance is permitted in periods for which financial statements have not yet been issued. Due to the diversity in the way Issue 96-19 has been previously applied, reaching a consensus may result in a significant change in accounting and financial reporting for certain entities that have not accounted for

modifications of debt instruments in a manner that is consistent with the consensus on these Issues. 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 for Task Force consideration:

View A: The consensus on these Issues should be applied retrospectively to debt instruments modified prior to the effective date of the consensus in accordance with the requirements in Statement 154.

View B: The consensus on these Issues should be applied retrospectively for instruments currently held for reporting periods beginning after the effective date of the consensus in accordance with the requirements in Statement 154. Restatement of previously issued financial statements for all debt instruments that have been settled prior to the effective date is not permitted.

View C: The consensus on these Issues should be applied prospectively for future modifications of debt instruments in reporting periods beginning after the effective date of the consensus. The disclosures required by Statement 154 should be made excluding those disclosures that require the effects of retroactive application. Restatement of previously issued financial statements is not permitted.

33. Proponents of View A believe that retrospective application would provide more useful information because prior-period balance sheet amounts and prior-period income statement amounts would be restated to reflect the consensus in these Issues, given the diversity in which Issue 96-19 had been previously applied. However, opponents counter that retrospective application would likely require a significant amount of time and effort to determine the fair value of conversion options before and after modification if a consensus is reached on View A of Issues 1 and 2 to include the change in the fair value of the conversion option in the Issue 96-19 analysis and to subsequently account for the effects of either an extinguishment or modification. The Task Force should consider the benefits and costs of requiring retrospective application and the need to provide entities with sufficient time to adopt the consensus.

34. Alternatively, Proponents of View B believe that retrospective application should be applied only for those debt instruments that are currently held at the balance sheet date that have been modified prior to the effective date of this consensus. Proponents of View B believe that this approach would require less effort to determine the fair value of conversion options before and after modification should View A be selected for Issues 1 and 2 than what would be required in View A. However, opponents counter that the application of View B could reduce the comparability of current and prior year financial statements.

35. Proponents of View C believe that the time and effort required to apply the transition guidance in either View A or View B would outweigh the benefits. Proponents of this View also note that it is difficult to apply the consensus on these Issues retroactively because it requires that estimates of fair value be made well after the fact. Therefore, they believe that the consensus to these Issues should be applied prospectively.