

**FASB Emerging Issues Task Force**

**Issue No.** 06-7

**Title:** Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

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**FASB Staff:** Roberge (ext. 274)/Stevens (ext. 226)

**EITF Liaison:** James Johnson

**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. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

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

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)

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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, exposes it for public comment, and it is ratified by the Board.**

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

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

EITF Issue No. 85-17, "Accrued Interest upon Conversion of Convertible Debt" (Issue 85-17)

EITF Issue No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion" (Issue 90-19)

EITF Issue No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes" (Issue 96-12)

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

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

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

EITF Issue No. 03-7, "Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)" (Issue 03-7)

EITF Issue No. 05-1, "Accounting for the Conversion of an Instrument That Became Convertible upon Issuer's Exercise of a Call Option" (Issue 05-1)

EITF Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in Issue No. 00-19" (Issue 05-2)

EITF Issue No. 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues" (Issue 05-7)

Statement 133 Implementation Issue No. A18, "Application of Market Mechanism and Readily Convertible to Cash Subsequent to the Inception or Acquisition of a Contract" (DIG Issue A18)

Statement 133 Implementation Issue No. K5, "Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues" (DIG Issue K5)

## **Background**

1. An entity may issue convertible debt with an embedded conversion option that is required to be bifurcated under FAS 133. Paragraph 12 of FAS 133 requires that an embedded conversion option be separated from the host contract and accounted for as a derivative if all of the following conditions are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic risks of the host contract
- b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument 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
- c. A separate instrument with the same terms as the embedded derivative instrument would be accounted for as a derivative instrument subject to the requirements of FAS 133.

2. An embedded conversion option that initially requires separate accounting as a derivative under FAS 133 may no longer meet the conditions for separate accounting as a derivative subsequent to its issuance. For example, a previously bifurcated instrument meets the conditions in Issue 00-19 to be classified in stockholders' equity if it was a freestanding instrument at issuance and, therefore, eligible for the scope exception under paragraph 11(a) of FAS 133. Since a reassessment of whether an embedded conversion option must be bifurcated under FAS 133 is conducted at each balance sheet date, questions have arisen as to how an entity should recognize the change when a previously bifurcated conversion option is no longer required to be bifurcated pursuant to FAS 133.

3. Consider the following example which will be used to illustrate the impact of each of the views articulated in this Issue Summary.

On January 1, 2006, Company A issues 100,000 convertible notes at a par value of \$1,000 per note, raising total proceeds of \$100,000,000. The notes bear interest at a fixed rate of 4 percent per annum, payable annually in arrears on December 31, and are scheduled to mature on December 31, 2010. Each \$1,000 par value note is convertible at any time into

the equivalent of 10 shares of Company A's common stock (that is, representing a conversion price of \$100 per share). Upon conversion, Company A must satisfy the par value of the debt obligation in cash and may satisfy the conversion spread (the excess of the if-converted value over par) in either cash or shares of stock at Company A's option. Regardless of Company A's stock price at conversion, the maximum number of shares that could ultimately be required to settle the conversion spread for the notes is 1,000,000 shares (10 shares per note × 100,000 notes outstanding).

In this example the embedded conversion option is indexed to Company A's own stock, which required the company to perform an evaluation of whether the embedded conversion option would be classified in stockholders' equity as if it were freestanding to determine if the scope exception in paragraph 11(a) of FAS 133 is met. Because the number of shares the holder will receive to satisfy the conversion spread is not fixed, the convertible debt instrument is not considered "conventional" pursuant to the guidance in Issue 05-2 and all of the requirements for equity classification in Issue 00-19 must be evaluated to determine whether the conversion option qualifies for the scope exception in paragraph 11(a) of FAS 133.

5. One of the requirements for an instrument to be classified in equity (refer to paragraph 19 of Issue 00-19) is that a company has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the derivative contract could remain outstanding. Considering its share requirements from other commitments that could require the issuance of common stock during the period the convertible notes could remain outstanding, Company A concludes that it does not have sufficient authorized but unissued common shares available to settle the conversion spread in shares (for illustrative purposes, assume Company A does not have sufficient authorized shares available to share-settle the conversion spread for any of the outstanding convertible notes). Accordingly, the embedded conversion option would not be classified in stockholders' equity if it were freestanding. Because the embedded conversion option meets the characteristics of a derivative in paragraphs 6–9 of FAS 133 and does not qualify for the scope exception in paragraph 11(a), at issuance, Company A is required to bifurcate the conversion option and account for it as a derivative under FAS 133.

6. At issuance (January 1, 2006), assume that the fair value of the embedded conversion option is \$200 per note (\$20,000,000 for the entire issuance). Company A would record the following (offering costs have not been reflected in this illustration):

Dr. Cash	\$100,000,000	
Dr. Discount on convertible debt		\$20,000,000
Cr. Convertible debt		\$100,000,000
Cr. Derivative liability – conversion option <sup>1</sup>		\$20,000,000

7. Using the effective interest method, amortization of the debt discount would be approximately \$3,331,000 for the year ended December 31, 2006 (overall interest yield of approximately 9.164 percent based on the \$20,000,000 initial debt discount, the 4 percent fixed interest coupon, and the 5-year term), and the net carrying value of the convertible notes would be approximately \$83,331,000 (\$833.31 per note) at the balance sheet date. At December 31, 2006, assume the fair value of the conversion option increases by \$20,000,000 (\$200 per note) to \$40,000,000 (\$400 per note). Company A would record the following for the year ended December 31, 2006:

Dr. Interest expense	\$7,331,000	
Dr. Loss on derivative	\$20,000,000	
Cr. Cash		\$4,000,000
Cr. Discount on convertible debt		\$3,331,000
Cr. Derivative liability – conversion option		\$20,000,000

8. On January 1, 2007, Company A obtains shareholder approval to increase its authorized common shares to a level that is sufficient for it to settle the conversion spread in shares for all outstanding convertible notes. Company A concludes, pursuant to Issue 00-19, that the

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<sup>1</sup> The separate presentation of the debt host and the embedded conversion option in the journal entries herein is for illustrative purposes and is not intended to provide any guidance regarding whether a bifurcated embedded derivative should be netted with the host instrument for balance sheet presentation purposes.

embedded conversion option meets the requirements of paragraph 11(a) of FAS 133 and should no longer be separately accounted for as a derivative pursuant to FAS 133.

9. When an entity is no longer required to bifurcate a previously bifurcated conversion option pursuant to FAS 133, there appears to be differing views on how an entity should recognize this change. For example, some entities have recognized the change by combining the derivative liability with the liability for the debt instrument. These entities believe that the related premium that results from this change should be amortized over the remaining term of the debt. Others, still, have reclassified the carrying value of the derivative liability to combine it with the liability for the debt instrument only to the extent the future amortization of a premium that results from the transaction does not result in a negative effective yield.

#### **Accounting Issue and Alternatives**

**How an issuer should account for a previously bifurcated conversion option in a convertible debt instrument if that conversion option no longer meets the bifurcation criteria in FAS 133.**

*View A: An entity should reclassify the carrying value of the liability for the conversion option to shareholders equity. The debt discount recorded at issuance should continue to be amortized over the remaining term of the instrument.*

10. Proponents of View A observe that under this view, the interest yield on the convertible debt instrument in periods subsequent to the reclassification of the previously bifurcated conversion option to shareholders equity provides the best representation of the issuer's economic borrowing costs by continuing to give accounting recognition to the proportion of those borrowing costs that were "paid" to the investors through the equity component of the convertible debt instrument.

11. Applying this view to the example, on January 1, 2007, Company A would record the following entry to reclassify the previously bifurcated conversion option:

Dr. Derivative liability – conversion option	\$40,000,000	
Cr. Additional paid-in capital		\$40,000,000
<i>(To reclassify the carrying value of the embedded conversion option to shareholders equity)</i>		

12. Upon recombination, the carrying value of the debt would be unchanged. In subsequent periods, the effective interest yield on the debt (9.164 percent in the Example) is not affected by the cessation of derivative accounting for the embedded conversion option.

13. Proponents of View A believe that when an equity component is provided to a lender in lieu of cash interest payments, the "equity" feature represents an integral component of the borrower's interest costs. For example, supporters of View A further observe that two issuers—one with an investment grade credit rating that issues nonconvertible debt; the other with a non-investment grade credit rating that issues convertible debt—may both issue debt at par with the same coupon rate of interest. However, the non-investment grade issuer would report a higher interest cost in its financial statements for all periods under View A, even after the embedded conversion option is no longer accounted for as a derivative, as the discount recorded at issuance is not eliminated and will continue to accrete as an interest cost.

14. Opponents of View A observe that separate accounting for the conversion option in equity is not permitted by APB 14, which specifies that no portion of the proceeds from the issuance of the types of convertible debt instruments described in paragraph 3 of that Opinion should be accounted for as attributable to the conversion feature. Accordingly, once an embedded conversion option is no longer separately accounted for as a derivative under FAS 133, opponents of View A observe that no existing authoritative literature permits the embedded conversion option to be accounted for separately from the debt host as a component of equity.

15. Proponents of View A argue that the guidance in APB 14 is not relevant to this Issue because the Task Force previously concluded that the guidance in APB 14 does not apply after the original issuance of an instrument. They refer to the guidance in paragraph 6 of Issue 05-7, which states, in part:

Opinion 14 only pertains to the accounting at issuance for convertible debt instruments and does not address the accounting for modifications to convertible debt instruments.

16. Since the issuer applied the guidance in FAS 133 at issuance (APB 14 did not apply), proponents of View A believe that the guidance in APB 14 would have no effect on the accounting treatment of a convertible debt instrument if the embedded conversion option is no longer separately accounted for as a derivative under FAS 133 in a period subsequent to issuance.

17. Proponents of View A also believe that this treatment is consistent with the guidance in paragraph 10 of Issue 00-19, which prohibits an entity from reversing gains or losses on an instrument that was previously accounted for as an asset or a liability when it is reclassified to equity and states, in part:

If the classification required under this Issue changes as a result of events during the period...the contract should be reclassified as of the date of the event that caused the reclassification...If a contract is reclassified from an asset or a liability to equity, gains or losses recorded to account for the contract at fair value during the period that the contract was classified as an asset or a liability should not be reversed.

18. Opponents of View A observe that the guidance prohibiting reversal of gains and losses upon reclassification to equity specifically applies to freestanding financial instruments accounted for pursuant to Issue 00-19 and does not apply to embedded conversion options, and they contend that the classification guidance in Issue 00-19 is to be used solely to determine whether the exception in paragraph 11(a) of FAS 133 would apply to an embedded derivative that would otherwise be separately accounted for under that Statement. These opponents support their observation by reference to paragraph 3 of Issue 00-19, which states, in part:

This Issue does not address accounting for either the derivative component or the financial instrument when the derivative component is embedded in and not detachable from the financial instrument.

Further, paragraph 68 of Issue 00-19 clarifies the applicability in analyzing the embedded feature under paragraph 12(c) of FAS 133 as follows:

The comment in paragraph 3 of Issue 00-19 that states that it does not "address the accounting for either the derivative component or the financial instrument when the derivative component is embedded in and not detachable from the financial instrument," does not negate the applicability of Issue 00-19 (as further discussed in paragraph 4 of Issue 00-19) in analyzing the embedded feature under paragraph 12(c) of Statement 133 as though it were a freestanding instrument.

In contrast, proponents of View A believe that consistent with the principles set forth in Issue 00-19, it is not appropriate to reverse prior period changes in a conversion option's fair value through amortization charges or credits in subsequent periods solely because it no longer meets the conditions for separate accounting apart from the debt host contract. View A proponents observe that such amortization charges or credits to reverse prior period fair value adjustments for the embedded conversion option would represent an accounting convention that does not reflect either the issuer's borrowing costs or the changes in the issuer's obligation under the embedded conversion option, which may increase or decrease in those subsequent periods.

*View B: An entity should combine the liability for the conversion option with the liability for the debt instrument and amortize any resulting premium or discount over the remaining term of the debt.*

19. Proponents of View B believe that the accounting for an embedded conversion option that no longer meets the criteria for separation under FAS 133 is analogous to an embedded derivative that is no longer separately accounted for upon adoption of new implementation guidance. DIG Issue K5 specifies that if an entity will no longer separately account for an embedded derivative upon adoption of new implementation guidance, 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.

20. Applying this view to the example, on January 1, 2007, Company A would record the following entry to recognize the fair value of the conversion option:

Dr. Derivative liability – conversion option	\$40,000,000
Cr. Convertible debt	\$40,000,000

*(To reclassify the carrying value (which equals fair value) of the embedded conversion option to debt)*

21. In subsequent periods, the interest yield on the debt in the Example would be negative (-1.601 percent), resulting in Company A reporting *interest income* of approximately \$2.0 million in 2007, \$1.9 million in 2008, \$1.8 million in 2009, and \$1.7 million in 2010, while the debt continues to be outstanding and interest payments of \$4 million per annum are paid.

22. Guidance similar to that provided in DIG Issue K5 is also contained in DIG Issue A18, which specifies that if a contract ceases to be a derivative pursuant to FAS 133 and an asset or a liability has been recorded for that contract, the carrying amount of that contract becomes its cost basis and the entity should apply other generally accepted accounting principles that are applicable to that contract prospectively from the date that the contract ceased to be a derivative. However, the guidance in DIG Issue A18 does not specifically address the subsequent accounting for a hybrid instrument containing an embedded derivative that no longer requires separate accounting as a derivative under FAS 133.

23. Proponents of View B observe that a conversion option embedded in a debt instrument does not meet the definition of a *freestanding financial instrument* and should not continue to be separately recognized once it is no longer required to be bifurcated under FAS 133. They refer to the following definition of a *freestanding financial instrument* from FAS 150:

A financial instrument that is entered into separately and apart from any of the entity's other financial instruments or equity transactions, or that is entered into in conjunction with some other instrument and is legally detachable and separately exercisable.

24. Because an embedded conversion option does not meet the definition of a freestanding financial instrument, View B supporters believe that it is required to be accounted for on a

combined basis with the debt host once it is no longer required to be separately accounted for as a derivative under FAS 133. Those supporters observe that there is no current guidance in U.S. GAAP that supports allocating any portion of an embedded conversion option to equity except in circumstances in which the convertible debt instrument is issued at a substantial premium (paragraph 18 of APB 14) or the conversion option is in-the-money at the commitment date (Issues 98-5 and 00-27). Accordingly, they believe that there is no basis for reclassifying any portion of an embedded conversion option to equity once it is no longer separately accounted for as a derivative.

25. View B proponents also refer to paragraph 7 of APB 14, which addresses the inseparability of an embedded conversion option and states:

The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore, the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he foregoes the right to redemption, and vice versa.

26. Proponents of View B acknowledge that Issue 00-19 prohibits the reversal of previous gains and losses when an asset or a liability is reclassified to equity. However, they observe that such guidance only applies to freestanding financial instruments and they do not believe it is appropriate to analogize to Issue 00-19 with respect to an embedded conversion option due to the inseparability of the debt and that embedded feature.

27. Opponents of View B believe that combining the carrying values of the conversion option and the debt host and amortizing any resulting premium would embody an accounting convention that does not reflect either the issuer's borrowing costs or the changes in the issuer's obligation under the embedded conversion option, which may increase or decrease in those subsequent periods. Those opponents also believe that reporting interest income in periods in which an entity has outstanding borrowings and is making interest payments provides misleading

information to investors. Accordingly, opponents of View B also believe that a consensus under View A or View C would result in the subsequent recognition of interest expense that more closely represents the issuer's borrowing costs (economic borrowing costs under View A and cash borrowing costs under View C).

28. Opponents of View B also observe that because the value transferred upon exercise of a conversion option is often not recognized in the issuer's financial statements, the accounting for a conversion option that is no longer bifurcated should differ from the treatment afforded to other types of embedded derivatives that may no longer require separate accounting as a derivative in a period subsequent to issuance. AIN APB 26 and Issue 85-17 state that the net carrying amount of the convertible debt, including any unamortized premium or discount, is credited to the equity upon conversion and no gain or loss is recognized.<sup>2</sup> As a result of that guidance, the difference between the cash proceeds received at issuance of the debt and the fair value of the shares transferred at conversion may not be given any accounting recognition. This differs from other embedded derivatives (for example, call options and put options) for which separate accounting as derivatives under FAS 133 may impact the timing of accounting recognition, but generally would not alter the net income statement impact over the life of the instrument.

29. Additionally, opponents of View B believe that the accounting recognition under this view could give rise to transaction structuring opportunities that are designed to achieve a specified accounting result. For example, an entity could issue a convertible debt instrument at par with a conversion feature that is in-the-money at the commitment date. The entity could structure the terms of the convertible debt instrument to fail the equity classification criteria in Issue 00-19 requiring the fair value of the embedded conversion option to be separated at issuance under FAS 133. Since the embedded conversion option is required to be bifurcated and accounted for separately, the guidance on the recognition of a beneficial conversion feature in Issues 98-5 and 00-27 would not apply. The entity could subsequently take an action (for example, increase the

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<sup>2</sup> There are some exceptions to this guidance on accounting for conversions. For example, Issue 00-27 (Issue 6) specifies that, for debt instruments with beneficial conversion features, all of the unamortized discount remaining at the date of conversion should be immediately recognized as interest expense. Issue 03-7 provides guidance on the settlement of a convertible instrument for which the accreted value is settled in cash and the conversion spread is settled in shares. Issue 05-1 requires extinguishment accounting when an instrument that became convertible upon the issuer's exercise of a call option did not contain a substantive conversion feature as of its issuance date.

number of its authorized shares) that would cause the embedded conversion feature to no longer require separate accounting under FAS 133. If such an action were taken shortly after issuance, it is likely the instrument would be recombined at an amount close to its par value and the issuer would have avoided accounting for the beneficial conversion feature.

30. Proponents of View B have considered the aforementioned structuring concerns and believe that the accounting prescribed in this view should clearly be precluded if an entity contemplated a transaction at the issuance date of the convertible debt instrument that would result in an effect where the conversion option is no longer required to be accounted for as a derivative under FAS 133 (for example, increase the number of its authorized shares) solely to avoid an undesirable accounting consequence (for example, recognition of a beneficial conversion feature).

*View B': An entity should combine the liability for the conversion option with the liability for the debt instrument. However, the combination shall not result in a carrying value that would cause the effective yield of the debt to become negative. The portion of the liability associated with the conversion option that cannot be combined with the existing carrying value because it would result in a negative effective yield should be reclassified to shareholders equity. Any resulting premium on the debt shall be amortized over the remaining term of the debt.*

31. Proponents of View B' agree with the views set forth in View B with the exception that when the liability for the conversion option is combined with the debt host, that combination should not cause the effective yield of the debt instrument to become negative (akin to an economic benefit from the perspective of the issuer). Consequently, they believe that the portion of the conversion option liability, if any, which cannot be combined with the existing carrying value of the debt host should be reclassified to shareholders equity. Proponents of View B' refer to FAS 15 and Issue 96-12, which contain guidance prohibiting the recognition of negative effective yields.

32. Applying this view to the example on January 1, 2007, Company A would record the following entry:

Dr. Derivative liability – conversion option	\$40,000,000	
Cr. Convertible debt		\$32,669,000
Cr. Additional paid-in capital		\$7,331,000

*(To reclassify a portion of the carrying value of the embedded conversion option to debt and to reclassify the remaining portion to additional paid-in capital.)*

In subsequent periods, the interest yield on the debt in the Example would be 0 percent, resulting in Company A reporting no interest costs in 2007–2010, while the debt continues to be outstanding and interest payments of \$4 million per annum are paid.

33. Opponents of View B' agree with the views expressed by the opponents of View B. They believe that reporting zero interest costs in periods in which an entity has outstanding borrowings and is making interest payments may provide misleading information to investors. Opponents of View B' believe that the need to create an exception to View B, to prevent an issuer from reporting interest income from outstanding borrowings, highlights their concern with the overall principle of View B, which is the basis of View B'. Opponents of View B' also believe that this view would create the same transaction structuring opportunities that may be available under View B. As a result, they believe View B' would likely require additional exceptions in order to preclude certain financial structuring activities. Opponents of View B' also observe that the requirement to reclassify a portion of the embedded conversion option to shareholders equity (to prevent a negative yield) might be considered inconsistent with the assertion expressed by proponents of View B that APB 14 prohibits classification of the conversion option in equity when it is no longer separately accounted for as a derivative under FAS 133.

*View C: An entity should combine the liability for the conversion option with the liability for the debt instrument to the extent that the adjusted carrying value of the convertible debt instrument equals the carrying value that would have existed at the recombination date had the conversion option not been previously separated. The portion of the liability for the conversion option that cannot be combined with the existing carrying value of the debt shall be reclassified to shareholders equity.*

34. Proponents of View C believe that an embedded conversion option must be recombined with the debt host once that conversion option is no longer separately accounted for as a derivative under FAS 133. However, proponents of View C believe that, upon recombination, the carrying value of the debt should equal the carrying value that would have resulted if the conversion option were never separated from the debt host, with any difference reported in equity.

35. Applying this view to the example, on January 1, 2007, Company A would record the following entry (assuming the conversion option was not in-the-money at the original commitment date):

Dr. Derivative liability – conversion option	\$40,000,000	
Cr. Convertible debt		\$16,669,000
Cr. Additional paid-in capital		\$23,331,000

*(To reclassify a portion of the carrying value of the embedded conversion option to debt (based on the carrying amount that would have resulted if the embedded conversion feature was never separated under FAS 133) with the remaining portion reclassified to additional paid-in capital)*

36. In subsequent periods, the interest yield on the debt in the Example would be 4 percent (assuming the conversion option was not in-the-money at the original commitment date), resulting in Company A reporting \$4 million of interest costs each year from 2007 – 2010, while the debt continues to be outstanding and interest payments of \$4 million per annum are paid. The carrying value of the convertible notes in the example provided above would be increased to par (their original issue amount) and reported interest costs in periods subsequent to recombination would equal the interest costs that would have resulted in those periods if the conversion option were never separated from the debt host.

37. Proponents of View C observe that this treatment minimizes transaction structuring opportunities that may result from an entity designing a conversion option that requires separate accounting recognition and subsequently taking an action that requires the instrument to be

recombined. Additionally, they believe there are a number of circumstances in U.S. GAAP where a portion of the value of an embedded conversion feature is allocated to equity. For example, paragraph 18 of APB 14 states that when convertible debt is issued at a substantial premium, there is a presumption that such premium represents paid-in capital. Additionally, when a debt instrument contains an embedded conversion option that is in-the-money at the commitment date, Issues 98-5 and 00-27 require that the intrinsic value of that embedded conversion option be classified in paid-in capital as a beneficial conversion feature. View C proponents observe that a substantial premium, as contemplated by paragraph 18 of APB 14, may often result upon recombination of an embedded conversion option, and those proponents believe that such premium should be classified in additional paid-in capital upon recombination.

38. Opponents of View C don't believe that a "hindsight" approach to the accounting of a convertible debt instrument upon recombination (that is, as if the conversion option were never bifurcated) is appropriate, because the embedded conversion option was required to be separated from the debt host and accounted for as a derivative under FAS 133 in prior periods. Some opponents of View C (who are also opponents of Views B and B') believe that the accounting for convertible debt pursuant to the provisions in APB 14 (and Issues 98-5 and 00-27) is only applicable at debt issuance, and, therefore, it would not be appropriate to determine the new carrying value of the convertible debt based on the amount that would have existed at the recombination.

39. Some opponents of View C believe that such treatment would be inconsistent with the guidance in DIG Issue K5 when an embedded derivative is no longer separately accounted for upon adoption of newly issued guidance. They also observe that under View C, prior fair value adjustments to an embedded conversion option while it was accounted for as a derivative may never be "reversed" through the income statement.

40. Proponents of View C believe that because the value transferred upon exercise of a conversion option is often not recognized by the issuer, the accounting for a conversion option that is no longer bifurcated should differ from the treatment afforded to other types of embedded derivatives under the guidance in DIG Issue K5. Additionally, proponents believe that there is

no economic rationale behind the assertion that previous fair value adjustments to an embedded conversion option should be reversed in subsequent periods, given that the fair value of that conversion option may continue to increase in periods subsequent to recombination, even though such increases would no longer be accounted for in the income statement.

### **International Convergence**

41. IAS 32 requires separate accounting for the conversion option in convertible debt instruments. In the application of IAS 32 to the example, the embedded conversion option would not be classified in equity in any period under IAS 32 because it provides one of the parties to the instrument (the issuer) a choice between settlement of the conversion spread in net cash or net shares. Additionally, the recognition of interest cost in subsequent periods would differ between IFRS and U.S. GAAP, even if View A were applied *and* an embedded conversion option were classified in equity under IAS 32. Under Statement 133, the debt host is measured as the difference between the proceeds from the convertible debt issuance less the fair value of the embedded conversion feature (a "with and without" method based on the fair value of the embedded conversion feature); however, under IAS 32, the debt host is measured as the fair value of a similar liability (including any embedded non-equity derivative features) that does not have the conversion option (a "with and without" method based on the fair value of the debt instrument without the conversion feature). Therefore, the model used under IAS 32 is not comparable to the views presented in this Issue Summary.

### **Interaction with Other Board Agenda Projects**

42. There is an initiative currently underway as part of the FASB liabilities and equity project to revisit the accounting related to convertible debt.

### **Transition, Effective Date and Disclosure**

43. The FASB staff believes that the consensus on this Issue should be applied through a change in accounting principle prospectively to all previously bifurcated conversion options in convertible debt instruments that no longer meet the bifurcation criteria in FAS 133. The consensus on this Issue should be effective in interim or annual periods beginning after December 15, 2006, irrespective of whether the debt instrument was entered into prior or

subsequent to the effective date of this Issue. Early application of this Issue is permitted in periods for which financial statements have not yet been issued. Retrospective application to previously issued financial statements is permitted.

44. An issuer shall disclose the following information when an embedded conversion option previously accounted for as a derivative under FAS 133 no longer meets the separation criteria under that standard:

- a. A description of the principal changes causing the embedded conversion option to no longer require bifurcation under FAS 133.
- b. The amount of the liability for the conversion option reclassified to stockholders' equity or the liability for the debt, depending on which view is adopted.