Notice for Recipients of This Proposed Statement 133 Implementation Issue

This proposed Implementation Issue clarifies that an option to acquire a fixed number of an issuer's equity shares with an exercise price that is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a foreign-currency-denominated convertible debt instrument) is not considered to be indexed only to the issuer's own stock for purposes of applying the scope exception in paragraph 11(a) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and, thus, does not meet the requirements for that scope exception. This proposed Implementation Issue also clarifies that the determination of whether an option to acquire a fixed number of an issuer's equity shares (including a conversion option embedded in a convertible debt instrument) is indexed to the issuer's own stock for purposes of applying the scope exception in paragraph 11(a) is not affected by the currency in which transactions are executed for the particular exchange(s) on which the issuer's equity shares are traded.

The Board invites individuals and organizations to send written comments on this proposed Implementation Issue. Comments are requested from those who agree with the provisions of this proposed Implementation Issue as well as from those who do not. Comments are most helpful if they identify the issues or the specific paragraph or paragraphs to which they relate and clearly explain the issue or question. Those who disagree with the provisions of this proposed Implementation Issue are asked to describe their suggested alternatives, supported by specific reasoning.

Responses must be received in writing by May 24, 2007. Interested parties should submit their comments by email to "*director@fasb.org*, File Reference: Proposed Statement 133 Implementation Issue C21, "Whether Options (Including Embedded Conversion Options) Are Indexed to both an Entity's Own Stock and Currency Exchange Rates." Those without email may send their comments to "*Larry Smith, Director of Technical Application & Implementation Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116,* File Reference: Proposed Implementation Issue C21." Responses should not be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB's website and will be included as part of the public record with other project materials.

Title:	Scope Exceptions: Whether Options (Including Embedded Conversion Options) Are Indexed to both an Entity's Own Stock and Currency Exchange Rates
Paragraph references:	11, 12, 61(k), 199, and 286
Date released:	April 19, 2007
Comment deadline:	May 24, 2007

QUESTIONS

1. Is an option to acquire a fixed number of an issuer's equity shares with an exercise price that is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a foreign-currency-denominated convertible debt instrument) considered to be **indexed to the issuer's own stock** for purposes of evaluating whether the option meets the scope exception in paragraph 11(a) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*?

2. Is an option to acquire a fixed number of an issuer's equity shares with an exercise price that is denominated in the issuer's functional currency (including a conversion option embedded in a functional-currency-denominated convertible debt instrument) considered to be **indexed to the issuer's own stock** for purposes of evaluating whether the option meets the scope exception in paragraph 11(a) of Statement 133 if the shares issuable upon exercise or conversion are traded only on exchanges (or other established marketplaces) on which trades are not executed in the issuer's functional currency?

BACKGROUND

Paragraph 11(a) of Statement 133 specifies that a contract issued or held by the reporting entity that is both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position shall not be considered to be a derivative instrument for purposes of applying Statement 133. If a freestanding option contract (for example, a stock purchase warrant) meets the scope exception in paragraph 11(a), it is classified as an equity instrument by the issuer and is not accounted for as a derivative instrument.

Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to that Statement if certain criteria are met. One of those criteria, set forth in paragraph 12(c), is that a separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11 of that Statement, be a derivative instrument subject to the requirements of Statement 133. Consequently, if the conversion option embedded in a convertible debt instrument meets the scope exception in paragraph 11(a), it would not be separated from the debt host contract and accounted for as a derivative by the issuer.

This Implementation Issue provides guidance for evaluating whether an option (including an embedded conversion option) is indexed to the issuer's own stock, which is the first criterion for the scope exception in paragraph 11(a). If an option is indexed to the issuer's own stock, it is still necessary to evaluate whether it is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument), which is the second criterion for the scope exception in paragraph 11(a). Other applicable generally accepted accounting principles, including EITF Issues No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," and No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in Issue No. 00-19," would be applied to determine whether an option is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument).

Illustrative Convertible Debt Instrument—Question 1

Company A, whose functional currency is the U.S. dollar (US$), issues convertible notes denominated in Euros (EUR) with a par value of EUR 1,000 per note. Each EUR 1,000 par value note is convertible at any time into 100 shares of Company A's common stock. Assume that the embedded conversion option meets the criteria to be separated from the host contract and be accounted for as a derivative instrument pursuant to Statement 133 unless the scope exception in paragraph 11(a) is met.

Illustrative Convertible Debt Instrument—Question 2

Company A, whose functional currency is the U.S. dollar, issues convertible notes denominated in US$ with a par value of US$1,000 per note. Each US$1,000 par value note is convertible at any time into 100 shares of Company A's common stock. Company A's common stock is publicly traded on a European stock exchange. Those shares are not traded on an exchange (or other established marketplace) on which trades are executed in US$. Assume that the embedded conversion option meets the criteria to be separated from the host contract and accounted for as a derivative instrument pursuant to Statement 133 unless the scope exception in paragraph 11(a) is met.

Statement 133 and Related Implementation Issue References

Paragraph 286 of Statement 133 specifies that "…contracts that provide for settlement in shares of an entity's stock but that are indexed in part or in full to something other than the entity's stock are to be accounted for as derivative instruments if the contracts satisfy the criteria in paragraphs 6–10 of this Statement. Those contracts are to be classified as assets or liabilities and not as part of stockholders' equity."

The fair value of a conversion option embedded in a debt instrument will always be affected by changes in interest rates, the issuer's credit standing, and changes in the issuer's stock price. However, implicit in the guidance in paragraphs 61(k) and 199 of Statement 133 is a presumption that it is not necessary for the issuer to consider an embedded conversion option's inherent indexation to interest rates and credit risk associated with the debt host when evaluating whether it qualifies for the scope exception in paragraph 11(a).

Statement 133 Implementation Issue No. C8, "Derivatives That Are Indexed to both an Entity's Own Stock and Currency Exchange Rates," indicates that a forward contract that is indexed to both an entity's own stock and currency exchange rates does not qualify for the exception in paragraph 11(a) of Statement 133 because the forward contract is indexed in part to something other than the entity's own stock (namely, currency exchange rates between the issuer's functional currency and the exercise price of the forward). Implementation Issue C8 also states that "paragraph 286 [of Statement 133] makes it clear that paragraph 11(a)(1) should be understood as being applicable to contracts that are indexed *only* to the issuer's own stock."

RESPONSES

Question 1

For purposes of applying the scope exception in paragraph 11(a), an option to acquire a fixed number of an issuer's equity shares with an exercise price that is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a foreign-currency-denominated convertible debt instrument) shall be considered dual-indexed to both the issuer's own stock and foreign currency exchange rates and, thus, does not meet the requirements for the scope exception in paragraph 11(a).

In the first Illustrative Convertible Debt Instrument above, upon conversion of the foreign-currency-denominated convertible debt instrument, the issuer is required to deliver a fixed number of shares (100 shares) in exchange for the reacquisition of a debt host instrument that is denominated in a currency other than the issuer's functional currency. Because the consideration received by the issuer (the debt host) is denominated in a currency other than the issuer's functional currency, its fair value to the issuer is affected by currency exchange rates. The exercise price of the embedded conversion option in this example varies based on currency exchange rates between the issuer's functional currency (US$) and the currency in which the debt host is denominated (EUR), so it is not considered to be indexed only to the issuer's own stock.

Question 2

For purposes of applying the scope exception in paragraph 11(a), an option to acquire a fixed number of an issuer's equity shares with an exercise price that is denominated in the issuer's functional currency (including a conversion option embedded in a functional-currency-denominated convertible debt instrument) shall not be considered indexed to currency exchange rates even though the shares issuable upon exercise or conversion are traded only on an exchange (or other established marketplace) on which trades are not executed in the issuer's functional currency. An equity share is not inherently "denominated" in a particular currency, so an issuer's analysis of whether an option (including an embedded conversion option) qualifies for the scope exception in paragraph 11(a) is not affected by the currencies in which third-party investors transact the issuer's shares.

In the second Illustrative Convertible Debt Instrument above, upon exercise of the embedded conversion option, the issuer is required to deliver a fixed number of shares (100 shares) in exchange for the reacquisition of a debt host instrument that is denominated in the issuer's functional currency. The consideration received by the issuer (the debt host) is denominated in the issuer's functional currency, so its fair value to the issuer is not affected by currency exchange rates. Thus, the exercise price of the embedded conversion option in this example is deemed to be fixed (as described above, it is not necessary for the issuer to consider an embedded conversion option's inherent indexation to interest rates and credit risk associated with the debt host for purposes of applying the scope exception in paragraph 11(a)). Additionally, the number of equity shares that are issuable upon conversion is fixed. Based on the guidance herein, neither the fair value of the consideration received by the issuer (the exercise price) nor the number of shares issuable upon conversion varies based on an underlying; therefore, the embedded conversion option is considered to be indexed only to the issuer's own stock.

EFFECTIVE DATE AND TRANSITION

The effective date of the guidance in this Implementation Issue for each reporting entity is the first day of the first fiscal quarter beginning after the Board-cleared guidance is posted to the FASB website. The guidance shall be applied to all financial instruments that the reporting entity enters into or modifies on or after that effective date. However, for all financial instruments and other transactions accounted for prior to the first fiscal quarter beginning after the Board-cleared guidance is posted to the FASB website, the effective date of this Implementation Issue shall be the beginning of the reporting entity's first fiscal year beginning after the Board-cleared guidance is posted to the FASB website. Early application of the guidance in this Implementation Issue to those financial instruments and other transactions is not permitted.

If an entity determines that a freestanding option contract (for example, a stock purchase warrant) that was classified as an equity instrument is required to be classified as a liability upon initial application of the guidance in Question 1 of this Implementation Issue, transition shall be achieved through a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position). If an entity determines that an embedded conversion option that was not separately accounted for as a derivative instrument is required to be bifurcated upon initial application of the guidance in Question 1, the embedded conversion option shall be measured at its fair value at the date of initial application, and the debt host contract shall be measured at the accreted value that would have been recorded at that date if the embedded conversion option had been bifurcated at issuance. The difference between (1) the aggregate carrying amount of the embedded conversion option and the debt host immediately after initial application and (2) the carrying amount of the convertible debt instrument immediately prior to initial application, including any related tax effects, shall be recognized as a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position).

If an entity determines that an option (including an embedded conversion option) that was separately accounted for as a derivative instrument qualifies for the scope exception in paragraph 11(a) upon initial application of the guidance in Question 2 of this Implementation Issue, the carrying amount of the liability for the option (that is, its fair value) shall be reclassified to equity upon initial application. Gains or losses recorded to account for the option at fair value during the period that the option was classified as a liability shall not be reversed. For an embedded conversion option, any debt discount that was recognized when the option was originally bifurcated from the convertible debt instrument shall continue to be amortized.

The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB. Constituents should send their comments, if any, to Larry Smith, Director of Technical Application & Implementation Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to director@fasb.org) by May 24, 2007.

Attachment A to Implementation Issue C21

The following table illustrates the application of this implementation issue.

Example	Issuer's Functional Currency	Currency of Option Exercise Price (1)	Exchange on Which the Issuer's Equity Shares Are Traded (2)	Is the Option Dual Indexed to the Issuer's Own Stock and Foreign Currency Exchange Rates?
1	US$	US$	Toronto (trades executed in CAN$)	No. Exercise price of option is denominated in the issuer's functional currency.
2	US$	CAN$	Toronto (trades executed in CAN$)	Yes. Exercise price of option is denominated in a currency other than the issuer's functional currency.
3	US$	CAN$	NYSE (trades executed in US$)	Yes. Exercise price of option is denominated in a currency other than the issuer's functional currency.
4	CAN$	CAN$	NYSE (trades executed in US$)	No. Exercise price of option is denominated in the issuer's functional currency.
5	CAN$	US$	NYSE (trades executed in US$)	Yes. Exercise price of option is denominated in a currency other than the issuer's functional currency.
6	CAN$	US$	Toronto (trades executed in CAN$)	Yes. Exercise price of option is denominated in a currency other than the issuer's functional currency.

Notes:

(1) An option to purchase the issuer's own stock can be freestanding (for example, a warrant) or embedded (for example, the conversion option embedded in a convertible debt instrument). As described in this Implementation Issue, the exercise price of an embedded conversion option is denominated in the same currency as the debt host.

(2) As described in this Implementation Issue, the currency in which third-party investors transact the issuer's equity shares does not affect the evaluation of whether an option meets the scope exception in paragraph 11(a) of Statement 133 in the issuer's financial statements. For instance, in Example 1 of this table, the option is not considered dual indexed to the issuer's own stock and foreign currency exchange rates even though the exercise price is denominated in US$ and transactions in the underlying equity shares are executed in CAN$ (on the Toronto stock exchange).

Attachment B to Implementation Issue C21

ALTERNATIVE VIEW

Three Board members do not support the issuance of this proposed Statement 133 Implementation Issue because they believe it represents only one possible way to interpret Statement 133 and, in some respects, is inconsistent with other provisions of Statement 133 that relate to convertible debt. By ruling out other reasonable interpretations, those Board members believe that the proposed guidance relating to convertible debt instruments inappropriately adds to the complexity of Statement 133 and the proliferation of rules-based guidance.

The three Board members do not object to the conclusion in the proposed guidance for freestanding instruments, and they acknowledge that it builds on the conclusion in Statement 133 Implementation Issue No. C8, “Derivatives That Are Indexed to both an Entity's Own Stock and Currency Exchange Rates” for freestanding instruments that are indexed to foreign currency and the entity’s own share price. However, because the scope of this proposed Implementation Issue also applies to equity derivatives embedded in debt instruments, it also seems reasonable to approach the analysis of the convertible debt instruments discussed in the proposed guidance using the paragraphs of Statement 133 that relate to embedded derivatives and foreign-currency-denominated financial instruments, namely, paragraphs 12 and, as it relates to the host, 15.

Freestanding derivatives (the subject of Implementation Issue C8) have a “strike price” that is denominated in a currency. When a conversion feature is embedded in a debt instrument, the debt instrument (host) is denominated in a currency, rather than the conversion feature per se. That difference raises questions about whether the foreign currency element should be ascribed to the conversion feature (and result in dual indexation) or solely to the host debt instrument in approaching the analysis of convertibles that are denominated in a foreign currency. The three Board members have identified different anchors in Statement 133 that would lead to different conclusions relating to the convertible debt instrument discussed in Issue 1 of the proposed guidance.

The proposed guidance anchors its analysis in an interpretation of paragraph 11(a). (The proposed guidance for convertible debt instruments distinguishes between a debt host that is denominated in the issuer’s functional currency (Issue 2) and a nonfunctional currency (Issue 1) and whether fluctuations in foreign currency exchange rates would affect the fair value of the debt instrument that would be tendered in a conversion.) The guidance proposes that if the fair value of the debt instrument would change based on fluctuations in exchange rates (that is, a nonfunctional currency), the embedded conversion feature is dual-indexed and, therefore, is not an equity instrument subject to paragraph 11(a). The proposed guidance also explains that the shares issuable upon exercise of the embedded conversion feature in Issue 2 (functional currency debt) are not denominated in any currency. However, the shares issuable upon exercise of the embedded conversion feature in the instrument in Issue 1 also are not denominated in any currency, so that does not aid in the analysis. On the contrary, it might suggest that the foreign currency element should be ascribed to the component of the instrument that does have cash flows that are denominated in a specific currency (that is, the debt host).

A different approach would be to consider the foreign currency element of a convertible debt instrument in a manner similar to the treatment of interest rate risk and credit risk in a convertible debt instrument under Statement 133; that is, interest rate risk and credit risk are viewed as clearly and closely related to the debt host under paragraph 12(a). While changes in both of those risks also clearly affect the fair value of the debt instrument that would be tendered in a conversion, those risks are not treated as dual (or triple) indexation under paragraphs 61(k) and 199 of Statement 133. Rather, those risks are ascribed to the debt host, and the conversion feature is treated like an equity instrument of the issuer. The conversion feature is not bifurcated because it meets the requirements of paragraph 11(a). Those Board members could view foreign currency risk in a similar manner; that is, it is an element of the debt host and would be subject to paragraph 15 of Statement 133 (which requires that the host be treated as an unsettled foreign currency transaction under Statement 52).[1] They note that this embedded derivative approach seems more consistent with the approach to analyzing convertible debt under Statement 133 and that the resulting accounting would be much simpler.

Those Board members do not believe this issue is pervasive enough to warrant the issuance of prescriptive guidance. They note that a more fundamental reconsideration of the accounting for these instruments is being addressed in the Board's project on liabilities and equity.

[1] Paragraph 15 states, "Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency."