Notice to Recipients of
This Proposed FASB Staff Position

This proposed FASB Staff Position (FSP) would clarify that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. Additionally, this proposed FSP would require that the issuer of a convertible debt instrument within its scope separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods.

This proposed FSP would nullify EITF Issues No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion," and 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)." This proposed FSP would amend EITF Issues No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," No. 99-1, "Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary," No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share," and No. 05-1, "Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option."

The Board invites individuals and organizations to send written comments on all matters in this proposed FSP. Comments are requested from those who agree with the provisions of this proposed FSP as well as from those who do not. Comments are most helpful if they identify the issues or specific paragraph or group of paragraphs to which they relate and clearly explain the issue or question. Those who disagree with the provisions of this proposed FSP are asked to describe their suggested alternatives and include their reasons for supporting those alternatives.

The Board requests that constituents provide comments on the following:

1. This proposed FSP requires that instruments within its scope be separated into their liability and equity components at initial recognition by (a) recording the liability component at the fair value of a similar liability that does not have an associated equity component and (b) attributing the remaining proceeds from issuance to the equity component. The rationale for the Board's decision to require this separation methodology for convertible debt instruments within the scope of this proposed FSP is described in Appendix B. Do you agree with this method of separation? Would this proposed FSP be easier to apply if separation were achieved by (a) recording the embedded conversion feature (equity component) at its fair value and (b) attributing the remaining proceeds from issuance to the liability component?
2. This proposed FSP provides guidance on the attribution of proceeds at initial recognition and at settlement for convertible debt instruments within its scope. It also requires that discounts on the liability component of instruments within its scope be amortized using the interest method over the expected life of a similar liability that does not have an associated equity component (considering the effects of prepayment features other than the conversion option). The remaining guidance in this proposed FSP, including much of the guidance on subsequent measurement and accounting for modifications, primarily consists of references to other applicable U.S. generally accepted accounting principles (GAAP). Does the inclusion of those references to other applicable U.S. GAAP improve the understandability of this proposed FSP, or should those references be eliminated from a final FSP?
3. Does the inclusion of the illustrative example in Appendix A improve the understandability of the guidance in this proposed FSP, or should that example be eliminated from a final FSP?

Responses must be received in writing by October 15, 2007. Interested parties should submit their comments by email to "director@fasb.org, File Reference: Proposed FSP APB 14-a." Those without email may send their comments to "Russell G. Golden, Director of Technical Application and Implementation Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116, File Reference: Proposed FSP APB 14-a." 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 included as part of the project record with other project materials.

PROPOSED FASB STAFF POSITION

No. APB 14-a

Title: Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)

Comment Deadline: October 15, 2007

Introduction

1. This FASB Staff Position (FSP) clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods.

2. This FSP nullifies EITF Issues No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion," and 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)." This FSP amends EITF Issues No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," No. 99-1, "Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary," No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share," and No. 05-1, "Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option."

Background

3. Issue 90-19 provided accounting and earnings per share guidance for three types of structured convertible debt instruments with the following characteristics:

Instrument A: Upon conversion, the issuer must satisfy the obligation entirely in cash based on the fixed number of shares multiplied by the stock price on the date of conversion (the conversion value).

Instrument B: Upon conversion, the issuer may satisfy the entire obligation in either stock or cash equivalent to the conversion value.

Instrument C: Upon conversion, the issuer must satisfy the accreted value of the obligation (the amount accrued to the benefit of the holder exclusive of the conversion spread) in cash and may satisfy the conversion spread (the excess conversion value over the accreted value) in either cash or stock.

4. The consensus in Issue 90-19 on accounting for Instrument A was nullified by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* because the embedded conversion option in that instrument is cash-settled and must be separately accounted for as a derivative. Prior to this FSP, Issue 90-19 required that Instrument B be accounted for as convertible debt (that is, in accordance with the guidance in paragraph 12 of Opinion 14). Issue 90-19 also required that Instrument C be accounted for like convertible debt (that is, in accordance with the guidance in paragraph 12 of Opinion 14) if the embedded conversion option would meet the requirements for equity classification in Issue 00-19 if it were a freestanding instrument.

FASB Staff Position

Scope

5. **This FSP applies to convertible debt instruments that, by their stated terms, may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative under Statement 133.**

6. Convertible preferred shares that are accounted for in equity (or temporary equity) are not within the scope of this FSP. However, convertible preferred shares that are mandatorily redeemable financial instruments and are classified as liabilities under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, shall be considered *convertible debt instruments* for purposes of determining whether those instruments are within the scope of this FSP. For example, convertible preferred shares that have a stated redemption date and also would **require** the issuer to settle the face amount of the instrument in cash upon exercise of the conversion option are mandatorily redeemable financial instruments under Statement 150 because they embody an unconditional obligation to redeem the instrument by transferring assets at a specified or determinable date (or dates).

7. Some convertible debt instruments require settlement of the if-converted value using the same form of consideration that holders of the underlying shares receive if conversion occurs in connection with a change-in-control transaction. Additionally, some convertible debt instruments require that an issuer's obligation to provide consideration for a fractional share upon conversion be settled in cash. The guidance in this FSP does not apply to convertible debt instruments that may provide for cash settlement (or partial cash settlement) only in the circumstances just described.

Recognition and Initial Measurement

8. Convertible debt instruments within the scope of this FSP are not addressed by paragraph 12 of Opinion 14.

9. **The liability and equity components of convertible debt instruments within the scope of this FSP shall be separately accounted for in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods.**

10. The issuer of a convertible debt instrument within the scope of this FSP shall first determine the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded features other than the conversion option) that

does not have an associated equity component. The issuer shall then determine the carrying amount of the equity component represented by the embedded conversion option by deducting the fair value of the liability component from the initial proceeds ascribed to the convertible debt instrument as a whole. If the transaction includes other unstated (or stated) rights or privileges in addition to the convertible debt instrument, a portion of the initial proceeds shall be attributed to those rights and privileges based on their fair value (before allocating the residual proceeds to the equity component) and accounted for according to their substance.

11. The guidance in this FSP does not affect an issuer's determination of whether an embedded feature should be separately accounted for as a derivative under Statement 133 and its related interpretations. If a convertible debt instrument within the scope of this FSP contains embedded derivatives other than the embedded conversion option (for example, embedded prepayment options), the guidance in Statement 133 shall be applied first to determine if any of those features must be separately accounted for as a derivative instrument. If an embedded feature (other than the embedded conversion option) is required to be separately accounted for as a derivative, it shall be separated from the liability component in accordance with the guidance in Statement 133 and its related interpretations.

12. Convertible debt instruments within the scope of this FSP are not eligible for the fair value option in accordance with the scope exception in paragraph 8(f) of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*.

13. Recognizing convertible debt instruments within the scope of this FSP as two separate components—a debt component and an equity component—may result in a basis difference associated with the liability component that represents a temporary difference for purposes of applying FASB Statement No. 109, *Accounting for Income Taxes*. The initial recognition of deferred taxes for the tax effect of that temporary difference shall be recorded as an adjustment to additional paid-in capital.

Subsequent Measurement

14. The excess of the principal amount of the liability component over its initial fair value shall be amortized to interest cost using the interest method, as described in paragraph 15 of APB Opinion No. 21, *Interest on Receivables and Payables*. For purposes of applying the interest method to instruments within the scope of this FSP, debt discounts shall be amortized over the expected life of a similar liability that does not have an associated equity component (considering the effects of prepayment features other than the conversion option). If an issuer uses a valuation technique consistent with an income approach to measure the fair value of the liability component at initial recognition, the issuer shall consider the periods of cash flows used in the fair value measurement when determining the appropriate discount amortization period.

15. The equity component (conversion option) is not remeasured as long as it continues to meet the conditions for equity classification in Issue 00-19. If the conversion option is required to be reclassified under Issue 00-19 from stockholders' equity to a liability measured at fair value, the difference between the amount previously recognized in equity and the fair value of the conversion option at the date of reclassification shall be accounted for as an adjustment to stockholders' equity. If a conversion option that was previously reclassified from stockholders' equity is subsequently reclassified back into stockholders' equity, gains or losses recorded to account for the conversion option at fair value during the period it was classified as a liability shall not be reversed. Reclassifications of the conversion option would not affect the accounting for the liability component.

Modifications and Derecognition

16. An issuer shall apply the guidance in EITF Issues No. 06-6, "Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments," and No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," to determine whether a modification of an instrument within the scope of this FSP should be accounted for as an extinguishment or as a modification. If a modification does not result in

extinguishment accounting under Issues 06-6 and 96-19, then the issuer shall determine a new effective interest rate for the liability component in accordance with the guidance in those Issues.

17. If an instrument within the scope of this FSP is modified such that the conversion option no longer requires or permits cash settlement upon conversion, the components of the instrument shall continue to be accounted for separately unless extinguishment accounting is required under Issues 06-6 and 96-19. If an instrument is modified or exchanged in a manner that requires extinguishment accounting under Issues 06-6 and 96-19 and the new instrument is a convertible debt instrument that may not be settled in cash upon conversion, the new instrument would not be subject to this FSP and other U.S. generally accepted accounting principles (GAAP) would apply (for example, paragraph 12 of Opinion 14).

18. If a convertible debt instrument that is not within the scope of this FSP is modified such that it becomes subject to this FSP, an issuer shall apply the guidance in Issues 06-6 and 96-19 to determine whether extinguishment accounting is required. If the modification is not accounted for as an extinguishment, the issuer shall apply the guidance in this FSP prospectively from the date of the modification. In that circumstance, the liability component is measured at its fair value as of the modification date. The carrying amount of the equity component represented by the embedded conversion option is then determined by deducting the fair value of the liability component from the overall carrying amount of the convertible debt instrument as a whole.

19. **If an instrument within the scope of this FSP is settled through the issuance of cash, stock, or any combination thereof, or if a modification or exchange of an instrument within the scope of this FSP is accounted for as an extinguishment, an issuer shall recognize the extinguishment of the liability component and the reacquisition of the equity component.** Regardless of the form of consideration transferred at settlement, instruments within the scope of this FSP shall be derecognized as follows:

a. Measure the fair value of the consideration transferred to the holder. If the transaction is a modification or exchange that is accounted for as an extinguishment, measure the new instrument at fair value (including both the liability and equity components if the new instrument is also within the scope of this FSP).

b. Allocate the fair value of the consideration transferred to the holder between the liability and equity components of the old debt instrument as follows:

   (1) Allocate a portion of the settlement consideration to the extinguishment of the liability component equal to the fair value of that component immediately prior to extinguishment. Any difference between the consideration attributed to the liability component and its carrying amount is recognized in the income statement as a gain or loss on debt extinguishment.

   (2) Allocate the remaining settlement consideration to the reacquisition of the equity component. Any difference between the consideration attributed to the equity component and its carrying amount is recognized in stockholders' equity.

   (3) If the transaction includes other unstated (or stated) rights or privileges in addition to the settlement of the convertible debt instrument, a portion of the settlement consideration shall be attributed to such rights and privileges based on their fair value (before allocating the residual settlement consideration to the equity component) and accounted for according to their substance.

20. An entity may amend the terms of an instrument within the scope of this FSP to induce early conversion, for example, by offering a more favorable conversion ratio or paying other additional consideration in the event of conversion before a specified date. In those circumstances, the entity shall recognize a loss equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of consideration issuable in accordance with the original conversion terms. The settlement accounting (derecognition) treatment described in paragraph 19 is then applied

using the fair value of the consideration that was issuable in accordance with the original conversion terms.

Effective Date and Transition

21. This FSP shall be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Early adoption is not permitted.

22. This FSP shall be applied retrospectively to all periods presented. The cumulative effect of the change in accounting principle on periods prior to those presented shall be recognized as of the beginning of the first period presented. An offsetting adjustment shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets) for that period, presented separately. An entity is not required to reclassify amounts between its opening equity accounts in circumstances in which an instrument within the scope of this FSP was not outstanding for any of the periods presented in the financial statements but was outstanding during an earlier period.

23. For convertible debt instruments that were modified after their original issuance date to provide for cash settlement (including partial cash settlement) upon conversion in a modification transaction that was not accounted for as an extinguishment, this FSP shall be applied retrospectively to the modification date. In those circumstances, the guidance in paragraph 18 of this FSP shall be applied to attribute the carrying amount of the instrument as of the modification date to its liability and equity components.

24. The transition disclosures set forth in paragraphs 17 and 18 of FASB Statement No. 154, *Accounting Changes and Error Corrections,* shall be provided.

Appendix A

IMPLEMENTATION GUIDANCE

A1. The following example illustrates the application of the guidance in this FSP. For purposes of this example, assume the embedded conversion option does not require separate accounting as a derivative instrument under Statement 133 because it qualifies for the scope exception in paragraph 11(a) of that Statement. For simplicity, transaction costs have been omitted from this example. Journal entry amounts in this example have been rounded to the nearest thousand.

> On January 1, 2007, Company A issues 100,000 convertible notes at their par value of $1,000 per note, raising total proceeds of $100,000,000. The notes bear interest at a fixed rate of 2 percent per annum, payable annually in arrears on December 31, and are scheduled to mature on December 31, 2016. 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 stated conversion price of $100 per share). The quoted market price of Company A's common stock is $70 per share on the date of issuance. Upon conversion, Company A can elect to settle the entire if-converted value (that is, the principal amount of the debt plus the conversion spread) in cash, common stock, or any combination thereof. The notes do not contain embedded prepayment features other than the conversion option.
>
> At issuance, the market interest rate for similar debt without a conversion option is 8 percent. The par value of Company A's common stock is $0.01 per share. The tax basis of the notes is $100,000,000, Company A is entitled to tax deductions based on cash interest payments, and its tax rate is 40 percent.
>
> On January 1, 2012, when the quoted market price of Company A's common stock is $140 per share, all holders of the convertible notes exercise their conversion options. Accordingly, those investors are entitled to aggregate consideration of $140,000,000 ($1,400 per note). At settlement, the market interest rate for similar debt without a

conversion option is 7.5 percent. Company A receives no tax deduction for the payment of consideration upon conversion ($140,000,000) in excess of the tax basis of the convertible notes ($100,000,000), regardless of the form of that consideration (cash or shares).

Recognition and Initial Measurement

A2. Upon issuance of the notes, the liability component is measured first, and the difference between the proceeds from the notes' issuance and the fair value of the liability is assigned to the equity component. The following illustrates how the fair value of the liability component might be calculated at initial recognition using a discount rate adjustment present value technique (an income approach). Depending on the terms of the instrument (for example, if the instrument contains prepayment features other than the embedded conversion option) and the availability of inputs to valuation techniques, it may be appropriate to determine the fair value of the liability component using (a) an expected present value technique (an income approach) and/or (b) a valuation technique based on prices and other relevant information generated by market transactions involving comparable liabilities (a market approach).

A3. The fair value of the liability component can be estimated by calculating the present value of its cash flows using a discount rate of 8 percent, the market rate for similar notes that have no conversion rights, as shown below.

Present value of the principal—$100,000,000 payable in 10 years	$ 46,319,349
Present value of interest—$2,000,000 payable annually in arrears for 10 years	13,420,163
Total liability component	$ 59,739,512
Total equity component ($100,000,000 – $59,739,512)	$ 40,260,488

A4. Company A records the following at initial recognition:

Cash	100,000,000	
Debt discount	40,260,000	
Debt		100,000,000
Additional paid-in capital		40,260,000
Additional paid-in capital	16,104,000	
Deferred tax liability ($40,260,000 × 40%)		16,104,000

Subsequent Measurement

A5. The notes do not contain embedded prepayment features other than the conversion option, so Company A concludes that the expected life of the notes is ten years (consistent with the periods of cash flows used to measure the fair value of the liability component) for purposes of applying the interest method. During the 5-year period from January 1, 2007, through December 31, 2011, Company A recognizes $26,304,228 of interest cost, consisting of $10,000,000 of cash interest payments and $16,304,228 of discount amortization under the interest method. During that period, Company A recognizes $10,521,691 of income tax benefits, consisting of $4,000,000 of current tax benefits (the tax effect of deductions for cash interest payments) and $6,521,691 of deferred tax benefits (partial reversal of the deferred tax liability due to amortization of the debt discount).

Derecognition

A6. Upon settlement of the notes, the fair value of the liability component immediately prior to extinguishment is measured first, and the difference between the fair value of the aggregate consideration remitted to the holder ($140,000,000) and the fair value of the liability component is attributed to the reacquisition of the equity component. The following illustrates how the fair value of the liability component might be calculated at settlement using a discount rate adjustment present value technique (an income approach). Depending on the terms of the instrument (for example, if the instrument contains prepayment features other than the embedded conversion option) and the availability of inputs to valuation techniques, it may be appropriate to determine the fair value of the liability component using (a) an expected present value technique (an income approach) and/or (b) a valuation technique based on prices and other relevant information generated by market transactions involving comparable liabilities (a market approach).

A7. The fair value of the liability component (which has a remaining term of 5 years at the settlement date) can be estimated by calculating the present value of its cash flows using a discount rate of 7.5 percent, the market rate for similar notes that have no conversion rights, as shown below.

Present value of the principal—$100,000,000 payable in 5 years	$ 69,655,863
Present value of interest—$2,000,000 payable annually in arrears for 5 years	8,091,770
Consideration attributed to liability component	$ 77,747,633
Consideration attributed to equity component ($140,000,000 – $77,747,633)	$ 62,252,367

A8. Regardless of the form of the $140,000,000 consideration transferred at settlement, $77,747,633 would be attributed to the extinguishment of the liability component and $62,252,367 would be attributed to the reacquisition of the equity component. The carrying amount of the liability is $76,043,740 ($100,000,000 principal – $23,956,260 unamortized discount) at the December 31, 2011 settlement date, resulting in a $1,703,893 loss on extinguishment.

A9. At settlement, Company A would record the following **assuming it elects to transfer consideration to the holder in the form of $100,000,000 cash and 285,714 shares of common stock (with a fair value of $40,000,000).** The $62,252,367 decrease to additional paid-in capital for the reacquisition of the conversion option, the $39,997,143 increase to additional paid-in capital from the issuance of common stock at conversion, and the $8,900,947 increase to additional paid-in capital to reverse the deferred tax liability relating to the unamortized debt discount at conversion, adjusted for the loss on extinguishment, are presented on a gross basis in this journal entry for illustrative purposes.

Debt	100,000,000	
Additional paid-in capital—conversion option	62,252,000	
Loss on extinguishment	1,704,000	
Deferred tax liability	9,583,000	
Debt discount		23,956,000
Cash		100,000,000
Common stock at par		3,000
Additional paid-in capital—share issuance		39,997,000
Deferred income tax benefit ($1,704,000 × 40%)		682,000
Additional paid-in capital [($23,956,000 – $1,704,000) × 40%]		8,901,000

A10. At settlement, Company A would record the following **assuming it elects to transfer consideration to the holder in the form of $140,000,000 cash:**

Debt	100,000,000	
Additional paid-in capital—conversion option	62,252,000	
Loss on extinguishment	1,704,000	
Deferred tax liability	9,583,000	
Debt discount		23,956,000
Cash		140,000,000
Deferred income tax benefit ($1,704,000 × 40%)		682,000
Additional paid-in capital [($23,956,000 – $1,704,000) × 40%]		8,901,000

Appendix B

BASIS FOR CONCLUSIONS

Background Information

B1. Prior to the issuance of this FSP, Issue 90-19 provided accounting guidance for certain types of convertible debt instruments that may be settled in cash upon conversion. One of those instruments, referred to as Instrument C in that Issue, requires that, upon conversion, the issuer satisfy the accreted value of the obligation (generally, the principal amount of the debt if the instrument was issued at par) in cash and the conversion spread in either cash or stock.

B2. The consensus in Issue 90-19, as revised, required that Instrument C be accounted for as convertible debt (that is, in accordance with the guidance in paragraph 12 of Opinion 14) but prescribed a diluted earnings-per-share methodology that was consistent with debt issued with detachable warrants. As a result, Instrument C generally has had less of a dilutive effect on the calculation of diluted earnings per share than a convertible debt instrument that requires application of the if-converted method. Because of the proliferation of such instruments in the marketplace over the past several years, questions were raised as to whether the accounting guidance in Issue 90-19 appropriately reflected the economic effects of those instruments. In response to those concerns, EITF Issue No. 07-2, "Accounting for Convertible Debt Instruments That Are Not Subject to the Guidance in Paragraph 12 of APB Opinion No. 14," was added to the EITF's agenda in January 2007 to reconsider the appropriateness of the guidance in Issue 90-19. The Task Force discussed Issue 07-2 at its March 15, 2007, and June 14, 2007, meetings but was unable to reach a conclusion. Accordingly, the Task Force agreed to discontinue discussion of that Issue and to remove it from the EITF's agenda.

B3. The Board believes that the consensus in Issue 90-19, as revised, on the accounting for Instrument C inappropriately expanded the application of the guidance in paragraph 12 of Opinion 14. That Opinion contains no discussion of convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. Additionally, the conclusion in paragraph 12 of Opinion 14 on the accounting for convertible debt instruments was based, in part, on the mutual exclusivity of the debt and the conversion option such that the holder cannot exercise the option to convert into equity shares unless the holder forgoes the right to repayment of the debt component. In contrast, the issuer of a convertible debt instrument with the characteristics of Instrument C is required to repay the debt in cash and can elect to settle the conversion spread in either cash or shares. Additionally, the diluted earnings-per-share treatment of convertible debt instruments with the characteristics of Instrument C is a treasury-stock-type method that is consistent with the diluted earnings-per-share treatment of debt issued with detachable warrants. The Board believes that the inconsistency between the accounting for those instruments (as convertible debt) and the diluted earnings-per-share treatment (as debt issued with detachable warrants) has led to a proliferation of convertible debt with the characteristics of Instrument C in the marketplace. The Board believes that those inconsistencies can provide misleading information to investors. This FSP clarifies that convertible debt instruments within its scope are not addressed by paragraph 12 of Opinion 14 and requires that the liability and equity components of those instruments be separately accounted for in a manner that will reflect the issuer's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods.

Scope

B4. This FSP applies to convertible debt instruments that may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative under Statement 133. Convertible preferred shares that are accounted for in equity (or temporary equity) are not within the scope of this FSP because those instruments do not contain a debt component under other guidance in U.S. GAAP.

Recognition and Initial Measurement

B5. Because convertible debt instruments within the scope of this FSP are not addressed by paragraph 12 of Opinion 14, the guidance in paragraph 18 of that Opinion requires that those instruments be accounted for based on their substance. Convertible debt instruments, including instruments within the scope of this FSP, consist of a liability component with a below-market interest coupon (the debt instrument) and an equity component (the conversion option). For purposes of this FSP, the Board decided to require that a convertible debt instrument that may be cash settled upon conversion be separated into its liability and equity components, with each component accounted for pursuant to other U.S. GAAP applicable to that component. Some Board members believe that all financial instruments indexed to an entity's own shares, including convertible debt instruments, should be measured at fair value with changes in fair value reported in earnings. However, such broad changes to all financial instruments indexed to an entity's own shares are being considered in the Board's liabilities and equity project and are beyond the scope of this FSP. The guidance in this FSP is intended to be consistent with current U.S. GAAP applicable to financial instruments indexed to, and potentially settled in, an entity's own stock, including Issue 00-19.

B6. The fundamental principle underlying the separation approach in this FSP is that an issuer of a convertible debt instrument that requires or permits partial cash settlement upon conversion should recognize the same interest cost it would have incurred had it issued a comparable debt instrument without the embedded conversion option. That is, the equity component is measured as a residual amount representing the interest cost that was "paid" with the conversion option. Accordingly, separation is achieved by measuring the fair value of a similar liability that does not have an associated equity component. This separation methodology is consistent with the approach required by International Accounting Standard 32, *Financial Instruments: Disclosure and Presentation*, for convertible debt instruments that contain liability and equity components under that standard. However, because the requirements for equity classification under U.S. GAAP (Issue 00-19) differ from the requirements for equity classification under IFRS (IAS 32), the guidance in this FSP does not converge with

IFRS. In accordance with IAS 32, the conversion option embedded in a convertible debt instrument that may be settled in cash upon conversion (including partial cash settlement) would be bifurcated and accounted for at fair value as a derivative under IAS 39, *Financial Instruments: Recognition and Measurement,* unless the fair value option is elected for the instrument in its entirety. To accomplish convergence in the accounting for instruments within the scope of this FSP, a broad-based reconsideration of Issue 00-19 would have been necessary, which the Board decided was beyond the scope of this project.

B7. The Board believes that the separation approach required by this FSP is less difficult to apply than other alternative approaches to separation. Paragraph BC30 of IAS 32 indicates that this separation methodology "removes the need to estimate inputs to, and apply, complex option pricing models to measure the equity component of some compound financial instruments." Unlike the separation methodology in Statement 133, this FSP does not require an issuer to measure the fair value of an embedded feature. Rather, the issuer is required to determine the fair value of a comparable debt instrument that has no conversion feature. FASB Statement No. 157, *Fair Value Measurements,* provides guidance on measuring fair value for financial reporting purposes. The fair value measurement framework in Statement 157 requires entities to use judgment when performing a fair value measurement for which there is no Level 1 input available (that is, when there is no quoted market price in an active market for an identical asset or liability). Estimating the fair value of the liability component of a convertible debt instrument within the scope of this FSP will require the issuer to apply such judgments.

B8. The inputs required to estimate the fair value of a nonconvertible debt instrument (for example, information about market interest rates and the issuer's credit standing) are expected to be available with limited effort for issuers of instruments within the scope of this FSP. Many of those entities currently have nonconvertible debt instruments outstanding for which the fair values are disclosed in accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. Additionally, convertible debt instruments issued in the United States often contain contingent interest provisions that enable the issuer to receive an income tax deduction based on its nonconvertible debt rate. Some entities purchase call options on their own stock concurrently with the issuance of convertible debt, and the two instruments are integrated for tax purposes, resulting in a tax deduction that is based on their nonconvertible debt rate. Consequently, many issuers of convertible debt instruments within the scope of this FSP already are obtaining the information necessary to determine the fair value of the liability component in order to adequately support deductions taken on their U.S. federal income tax returns.

B9. After considering the factors described in this appendix, the Board concluded that the financial reporting benefits of separately accounting for the liability and equity components of a convertible debt instrument that may be settled in cash using the separation methodology described in this FSP outweigh the costs or practical difficulties associated with the application of that treatment.

B10. Other guidance in U.S. GAAP contains separation or allocation requirements that are intended to accomplish objectives other than measuring the amount of a borrower's interest cost that is "paid" with an embedded equity component. For example, Statement 133 requires that derivative instruments within the scope of that Statement be measured initially and subsequently at fair value. Consequently, an embedded derivative (including an embedded conversion option) that requires separation under Statement 133 is initially measured at fair value, with the residual proceeds attributed to the host contract. That separation methodology is intended to measure the embedded derivative at its fair value, not to generate a particular interest cost on the debt host.

B11. Opinion 14 requires that the proceeds from an offering of nonconvertible debt and equity-classified warrants be allocated on a relative fair value basis between the debt and the warrants. That guidance is intended to provide an allocation mechanism between two freestanding financial instruments, not to generate a particular interest cost on the debt instrument. Additionally, a relative fair value separation methodology is more difficult to apply than the separation methodology under this FSP because it requires fair value measurements for both the liability component and the equity component.

B12. This FSP requires issuers to separately account for the liability and equity components of convertible debt instruments within its scope. In some jurisdictions, the tax basis of a convertible debt instrument at initial recognition includes the entire amount of the proceeds received at issuance. As a result, a taxable temporary difference arises from the initial recognition of the equity component separately from the liability component. The Board decided that the initial recognition of deferred taxes for the tax effect of the temporary difference should be recorded as an adjustment to additional paid-in capital. That treatment is consistent with the consensus in EITF Issue No. 05-8, "Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature."

Subsequent Measurement

B13. The subsequent measurement guidance in this FSP requires the application of other U.S. GAAP (Opinion 21 and Issue 00-19, respectively) to the liability and equity components. Convertible debt instruments within the scope of this FSP frequently contain prepayment features (for example, put and call options) other than the embedded conversion option. For purposes of separating the liability and equity components of instruments within the scope of this FSP at initial recognition, an issuer is required to measure the fair value of a similar liability (including any embedded features other than the conversion option) that does not have an associated equity component. In accordance with that guidance, prepayment features other than the conversion option are considered when measuring the fair value of the liability component at initial recognition. Similarly, the Board decided that the subsequent measurement guidance in this FSP should specify that debt discounts be amortized using the interest method over the expected life of a similar liability that does not have an associated equity component (considering the effects of prepayment features other than the conversion option). That treatment is consistent with the objective that an issuer's reported interest cost from convertible debt instruments within the scope of this FSP should reflect its nonconvertible debt borrowing rate.

B14. The Board is aware that for debt instruments containing prepayment features, different accounting policies have been applied in practice for purposes of estimating the amortization period for discounts, premiums, and deferred transaction costs under Opinion 21. The guidance in this FSP on the determination of an appropriate discount amortization period is not intended to be a broad-based interpretation applicable to debt instruments that are not within the scope of this FSP.

Modifications and Derecognition

B15. For purposes of determining whether a modification or an exchange of convertible debt instruments within the scope of this FSP should be accounted for as an extinguishment, the Board concluded that other applicable U.S. GAAP (Issues 06-6 and 96-19) should be applied. If an instrument within the scope of this FSP is modified such that the conversion option no longer requires or permits partial cash settlement upon conversion, the components of the instrument would continue to be accounted for separately unless extinguishment accounting is required under Issues 06-6 and 96-19. That guidance is consistent with the EITF's recent conclusions in Issue 06-6 and EITF Issue No. 06-7, "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," that Opinion 14 only applies at inception. Therefore, a convertible debt instrument within the scope of this FSP that is originally separated into liability and equity components should not be recombined at a later date due to a modification that is not accounted for as an extinguishment. Rather, the liability component should continue to be accreted to its principal amount based on the modified terms of the instrument.

B16. The principle underlying the guidance in this FSP on modifications and settlements is that upon any settlement of a convertible debt instrument within the scope of this FSP, an entity is extinguishing the liability component and reacquiring the equity component. Accordingly, the fair value of the consideration transferred to the holder at settlement (regardless of the form of that consideration) is attributed between the liability and equity components using the same methodology that was applied when the original proceeds received by the issuer were attributed to those components.

B17. The Board decided that if an entity amends the terms of a convertible debt instrument within the scope of this FSP to induce early conversion, the entity must recognize a loss equal to the fair value of all securities and other consideration in excess of the fair value of the consideration issuable pursuant to the original conversion terms. That treatment is consistent with the accounting for such additional consideration under paragraph 3 of FASB Statement No. 84, *Induced Conversions of Convertible Debt*. No portion of the additional consideration paid to the holder to induce early conversion is attributed to equity because that payment embodies an incremental financing cost, rather than a cost to reacquire the existing equity component.

Earnings per Share

B18. This FSP does not affect the application of the guidance in FASB Statement No. 128, *Earnings per Share*, and its related interpretations on calculating basic and diluted earnings per share. Issue 90-19 provided interpretive guidance on the diluted earnings-per-share treatment of convertible debt with the characteristics of Instrument C (Instrument C is described in paragraph 3 of this FSP). That Issue has been nullified by this FSP. Example 2 of Issue 04-8, which previously referred to the diluted earnings-per-share guidance in Issue 90-19, has been amended to incorporate that guidance directly.

Transition

B19. The Board considered a number of factors in reaching its conclusion that this FSP should be applied retrospectively. For example, convertible debt instruments that require or permit cash settlement (including partial cash settlement) upon conversion were relatively uncommon before the consensus on Issue 90-19 was revised in January 2002. Additionally, the number of convertible debt instruments that require or permit cash settlement (including partial cash settlement) upon conversion increased after the consensus on Issue 04-8 eliminated the diluted earnings-per-share benefits of contingently convertible debt instruments (Co-Cos) that contain a market price trigger. Because information about market interest rates for recent years is available, entities should have access to the inputs that would be required to measure the fair value of the liability component of a convertible debt instrument within the scope of this FSP as of its issuance date to apply the provisions of this FSP retrospectively.

B20. Convertible debt instruments within the scope of this FSP frequently incorporate features that enable the issuer to obtain a tax deduction based on its nonconvertible debt borrowing rate (for example, purchased call options on the issuer's own stock that achieve tax integration with the convertible debt and contingent interest provisions). Consequently, many of those issuers already have obtained the necessary information about market interest rates and their own credit standing to measure the fair value of the liability component of a convertible debt instrument within the scope of this FSP as of its issuance date in order to apply the provisions of this FSP retrospectively.

B21. The FASB's conceptual framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. Paragraph B7 of Statement 154 specifies that "the Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data." After considering the availability of information that would be necessary to apply the provisions of this FSP retrospectively, the Board concluded that the benefits of improved comparability through retrospective application outweighed the related costs of that transition approach. Accordingly, the Board decided that the guidance in this FSP should be applied retrospectively to all periods presented.

Appendix C

EFFECT ON EITF ISSUES

C1. This FSP nullifies EITF Issues No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion," and 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 90-19)."

C2. EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

a. Paragraph 3:

> This Issue applies to (a) convertible debt instruments and convertible shares (collectively, convertible securities) with beneficial conversion features that must be settled in stock and (b) convertible shares with beneficial conversion features ~~to those~~that give the issuer a choice of settling the obligation in either stock or cash. This Issue also applies to instruments with beneficial conversion features that are convertible into multiple instruments, for example, a convertible preferred stock that is convertible into common stock and detachable warrants. In addition, this Issue applies to instruments with conversion features that are not beneficial at the commitment date but that become beneficial upon the occurrence of a future event, such as an initial public offering. This Issue does not apply to instruments within the scope of FSP APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)."

C3. EITF Issue No. 99-1, "Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary," is amended as follows:

a. Paragraph 1:

An entity may issue debt that is convertible into the stock of a consolidated subsidiary, or the consolidated subsidiary may issue debt that is convertible into its own stock. Opinion 14 and Statement 133 provide potentially conflicting guidance on the accounting for certain convertible debt instruments falling within their respective scopes. Paragraph 12 of Opinion 14 prohibits separation of a nondetachable conversion feature embedded in convertible debt securities, including debt convertible into the stock of an affiliated company. Paragraph 12 of Statement 133 requires the separation of the embedded conversion feature, provided certain criteria are met, including a criterion that a separate instrument with the same terms as the embedded instrument must meet the definition of a derivative instrument. Paragraph 11(a) of Statement 133 provides that a reporting entity shall not consider a contract to be a derivative if it is both (a) indexed to its own stock and (b) classified in stockholders' equity in its statement of financial position. This Issue does not apply to convertible debt instruments that may require cash settlement by the issuer of an in-the-money conversion feature, that provide the holder an option to receive cash for an in-the-money conversion feature, <u>that are within the scope of FSP APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)," </u>or that have a beneficial conversion feature.

C4. EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," is amended as follows:

a. Paragraph 1:

Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," addresses the accounting for convertible debt instruments and convertible preferred stock (collectively, convertible instruments) with nondetachable conversion options that are in-the-money (see Part II, Issue 1 for additional guidance on determining when a conversion option is in-the-money) at the commitment date. Issue 98-5 also addresses an issuer's accounting for convertible instruments that have conversion prices that are variable based on future events. Issue 98-5 does not apply to instruments within the scope of FSP APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)." The Task Force reached a consensus on Issue 98-5 at the May 19–20, 1999 meeting. Subsequent to the consensus, a number of issues about the application of the Issue 98-5 model have been raised.

C5. EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share," is amended as follows:

a. Exhibit 04-8A:

Example 2–Instrument C (as described in paragraph 3 of FSP APB 14-a) ~~in Issue 90-19~~ with a market price trigger

In Example 2, the assumptions are the same as Example 1 except that the issuer of the contingently convertible debt must settle the principal amount of the debt in cash and it may settle the conversion premium in either cash or stock. The holder of the instrument is only entitled to the conversion premium if the share price exceeds the market price trigger. The contingently convertible instrument is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X is ~~$10,000~~$9,980, and the average share price for the year is $64.

The if-converted method should not be used to determine the earnings-per-share implications of convertible debt with the characteristics described in this example. There would be no adjustment to the numerator in the diluted earnings-per-share computation for the cash-settled portion of the instrument because that portion will always be settled in cash. The conversion premium should be included in diluted earnings per share based on the provisions of paragraph 29 of Statement 128 and Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share." The convertible debt instrument in this example is subject to other applicable guidance in Statement 128 as well, including the antidilution provisions of that Statement.

In this example, basic EPS is ~~$5.00~~$4.99,[4a] and ~~applying the method required by Issue 90-19 for this instrument results in~~ diluted earnings per share is ~~of~~ ~~$4.99~~$4.98.[5]

[4a]Basic EPS = IACS ÷ SO = $9,980 ÷ 2,000 shares = $4.99 per share.

[5]Potential common shares = (Conversion spread value) ÷ (Average share price) = $14 × 20 shares ÷ $64 = 4.38 shares.

Diluted EPS ~~(computed in accordance with Issue 90-19)~~ = IACS ÷ (SO + Potential common shares) = (~~$10,000~~$9,980) ÷ (2,000 + 4.38) shares = ~~$4.99~~$4.98 per share.

C6. EITF Issue No. 05-1, "Accounting for the Conversion of an Instrument That Became Convertible upon the Issuer's Exercise of a Call Option," is amended as follows:

a. Paragraph 4:

This Issue applies to the issuance of equity securities to settle a debt instrument that was not otherwise currently convertible but became convertible upon the issuer's exercise of a call option when the issuance of equity securities is pursuant to the instrument's original conversion terms. Statement 84 provides guidance about conversions pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance to induce conversion and Issue 06-6 provides guidance about modifications to embedded conversion options. The guidance in this Issue does not apply to debt instruments that are within the scope of FSP APB 14-a, "Accounting for Convertible Debt

Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)."

b. Paragraph 10:

~~When extinguishment accounting is required under this Issue upon the settlement of a debt instrument with the characteristics of Instrument C in Issue 90-19, the reacquisition price for the debt would include the cash payment for the accreted value of the debt and fair value of the equity instruments issued to settle the conversion spread. Pursuant to the guidance in Issue 03-7, for the settlement of a debt instrument with the characteristics of Instrument C as described in Issue 90-19 that is accounted for as a conversion under this Issue, the reacquisition price of the debt would not consider any shares transferred to settle the embedded equity instrument (the excess conversion spread in Issue 90-19).~~