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FASB's Proposed Changes to Convertible Debt Accounting Would Have Big Impact

by Magnus Orrell and Bob Uhl, Deloitte & Touche LLP

Introduction

The Financial Accounting Standards Board (FASB) recently published proposed Staff Position (FSP) No. APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)." If finalized, the FSP would have a major impact on the financial statements of many issuers of convertible debt securities.[1] Issuers of these instruments are well advised to study this proposal and its potential effects on their financial statements.

The proposed accounting requirements would apply to convertible debt securities that, upon conversion, may be settled fully or partially in cash ("convertible debt securities that may be cash-settled"). One example is a convertible debt security that gives the issuer the option to settle the principal amount of the security in cash and to settle any conversion value in excess of the principal amount in shares (sometimes known as "Instrument C").[2] Such securities have become popular in recent years, in part because under existing accounting literature, interest expense recognition and calculation of earnings per share are more favorable for these securities than for other types of debt securities.

The proposed FSP would not affect the accounting for more traditional types of convertible debt securities that cannot be settled in cash upon conversion. Such convertible debt securities continue, typically, to be accounted for wholly as debt.[3]

The FASB is inviting comments on the proposal until October 15, 2007, and expects to issue final requirements before the end of this year. The new requirements would apply to financial statements issued for fiscal years beginning after December 15, 2007, including interim periods within those fiscal years. That is, most entities would apply the guidance for the first time in their first 2008 interim financial reports. **The guidance would be retrospectively applied in prior-period financial statements issued for comparison purposes.**

Issuers of [convertible debt securities] are well advised to study this proposal and its potential effects on their financial statements.

[1] Before the proposed FSP, this issue was discussed in 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, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants*," but no consensus was reached.
[2] EITF Issue No. 90-19, "Convertible Bonds With Issuer Option to Settle for Cash Upon Conversion."
[3] In accordance with Opinion 14.

Initial Recognition — Split Accounting

Under the proposed FSP, issuers of convertible debt securities within its scope would — for accounting purposes — separate these securities into two components:

- A debt component representing the issuer's contractual obligation to pay principal and interest.
- An equity component representing the holder's option to convert the debt security into equity of the issuer or an equivalent amount of cash.

This accounting treatment differs from current accounting requirements, which generally treat convertible debt securities that may be cash-settled solely as debt.[2] Under the proposed FSP, an issuer would first allocate proceeds to the debt component on the basis of the fair value of a similar debt instrument that does not have the conversion feature; the remainder of the proceeds would be allocated to the equity component.

Under the proposed FSP, an issuer would first allocate proceeds to the debt component on the basis of the fair value of a similar debt instrument that does not have the conversion feature; the remainder of the proceeds would be allocated to the equity component.

For example, if an entity were to issue convertible debt that may be cash-settled for proceeds of $10,000, existing accounting guidance typically would treat the entire amount of $10,000 as debt even though, say, $4,000 may be attributable to the equity conversion option. Under the proposed FSP, however, if an entity were to issue a convertible debt security that may be cash-settled for proceeds of $10,000, the issuer would first need to estimate the fair value of the debt component (say, $6,000) and would record that amount as debt. The issuer would then allocate the remainder of the proceeds (in our example, $4,000) to the equity component and record that amount in equity. This process of splitting the proceeds between the liability and equity components sometimes is referred to as "split" accounting.

Embedded Features

In practice, convertible debt securities often contain put options, call options, and other embedded features in addition to the equity conversion option. Under the FASB's proposal, the issuer's estimate of the liability component's fair value would reflect those features. For example, if the convertible debt security can be called from the investor by the issuer or put back to the issuer by the investor, the value of those call or put features would be reflected in the issuer's estimate of the fair value of the liability component. The accounting literature on derivatives continues to apply in the determination of whether any of those features should be accounted for separately as derivatives.[4]

Subsequent Accounting

The application of split accounting to the debt and equity components will generally result in a debt discount (e.g., $4,000 in the above example). The FSP would require that the interest method over the expected life[5] of the debt be used in accreting the difference to interest expense, causing the amount of interest expense reported in each period to be greater than the computation under existing GAAP and greater than the cash coupon.

Under the proposed FSP, the equity conversion option would not be remeasured as long as it continues to meet the conditions for equity classification in the accounting literature.[6] If the equity conversion option no longer qualifies for equity classification, it would be reclassified from equity to a liability and be measured at fair value.

[4] If the accounting literature on derivatives requires that the conversion option itself be bifurcated and accounted for as a derivative separately from the debt security, then the convertible debt security would be outside the scope of the proposal on convertibles that may be cash-settled.

[5] In the determination of the expected life of the instrument, exercise of the conversion option is ignored for instruments subject to the proposed FSP. Thus, the expected life of a convertible debt security with no prepayment features is the period from issuance until maturity even though the instrument may be converted before reaching maturity.

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

Reclassification of the conversion option from equity to a liability would not affect the accounting for the debt component — that is, the two components would continue to be accounted for separately (i.e., separate debt liability and derivative liability).

The following table summarizes the expected impact of the proposed FSP on the financial statements of an entity that has issued convertible debt securities that may be cash-settled:[7]

Item	Impact	Why?
Interest Expense	Increase	The separation of the equity component results in a debt discount that must be accreted to interest expense.
Earnings	Decrease	The increase in interest expense attributable to the accretion of the debt discount reduces net earnings.
Debt	Decrease	The allocation of part of the proceeds to equity reduces the carrying amount of debt.
Equity	Increase	The allocation of part of the proceeds to equity increases equity.
Earnings per Share	Decrease	Note that the proposal does not change the method for determining earnings per share (e.g., Instrument C is still not subject to the if-converted method). However, the increase in interest expense will decrease income available to common shareholders.

The application of split accounting to the debt and equity components will generally result in a debt discount.

The appendix below includes a numerical example illustrating the FSP's potential effect.

The proposed FSP would also change the accounting for exercise of a conversion option before maturity. While the issuer is required to measure at fair value the consideration transferred to the instrument's holder upon conversion and allocate this consideration among the debt component, the equity component, and other rights, the proposed accounting will generally result in the issuer's recognizing a gain or loss for the difference between the carrying value of the debt component and the fair value of the debt component just before conversion.

Transition

The FASB is proposing that, unless it is impracticable to do so, the new requirements should be applied retrospectively to all periods presented. There is no grandfathering for existing or previously outstanding convertible debt securities that may be cash-settled, meaning that issuers will need to apply the proposed requirements both (1) to currently outstanding convertible debt securities and (2) to securities that no longer exist as of the effective date (but existed during prior periods presented).

[7] In the accounting for income taxes, there may be effects other than those noted in the table.

Appendix

Numerical Example

The following example illustrates the potential impact of the proposed new accounting requirements for convertible debt that may be cash-settled. The example compares the reported amounts of interest expense and debt under existing generally accepted accounting principles (GAAP) with those under the proposed new accounting requirements.

The example assumes that an entity issues 10-year convertible debt at par for proceeds of $1,000 on December 31, 2007. The issuer pays interest annually at the end of each year at an interest rate of 1 percent on the principal amount (i.e., $10 per year). The issuer's nonconvertible borrowing rate is 8 percent. The maturity date of the convertible debt is January 1, 2018. To simplify the illustration, we have assumed that issuance costs are zero, ignored any tax effects, and assumed that the convertible debt does not have any embedded features other than the conversion option.

Under existing GAAP, the entity would recognize the issuance of the convertible debt solely as debt. The carrying amount of the debt would equal its principal amount of $1,000, and in each year the entity would report interest expense equal to cash interest paid of $10. In other words, the effective yield is 1 percent.

Under the proposed accounting requirements for convertible debt that may be cash-settled, the entity would recognize the issuance of the convertible debt as part debt, part equity. The initial carrying amount of the debt component would be the fair value of the debt component, $530 (rather than the $1,000 reported under existing GAAP). We calculated this amount by using the issuer's nonconvertible borrowing rate of 8 percent to discount the cash interest and principal payments. The amount recognized in equity would be $470 (i.e., the difference between the proceeds received and the initial carrying amount of the debt component).

The difference between the initial carrying amount of the debt component of $530 and principal amount of $1,000 would be accreted to earnings as an increase to interest expense at an effective yield of 8 percent. In 2008, for instance, interest expense would be $42 (rather than the $10 reported under existing GAAP). In each subsequent period, interest expense would increase to reflect the amortization of the debt discount. In 2017, for example, interest expense would be $75 under the proposed FSP but $10 under existing GAAP.

Fiscal Year	Reported Interest Expense		Carrying Amount of Debt	
	Existing GAAP	Proposed GAAP	Existing GAAP	Proposed GAAP
2007			$ 1,000	$ 530
2008	$ 10	$ 42	1,000	563
2009	10	45	1,000	598
2010	10	48	1,000	636
2011	10	51	1,000	676
2012	10	54	1,000	721
2013	10	58	1,000	768
2014	10	61	1,000	820
2015	10	66	1,000	875
2016	10	70	1,000	935
2017	10	75	1,000	1,000
Total	$ 100	$ 570		

Note: Numbers are rounded.

Under the proposal, the $470 amount initially recognized in equity would not be remeasured as long as the equity conversion option continues to meet the conditions for equity classification. Under existing GAAP, no amount is recognized in equity before conversion.

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