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FASB to Propose Separate Accounting for the Conversion Options of Many Convertible Bonds

Issuers of convertible debt that may be settled wholly or partly in cash will have to account for the debt and equity components separately if a soon-to-be released proposed FASB Staff Position follows the course set by decisions at today's FASB meeting. The proposal would require separate accounting to be applied retrospectively to both new and existing convertible instruments within the proposal's scope and would thereby affect net income and earnings per share reported by many issuers of these convertible instruments.

The proposed guidance would apply to any convertible instrument that upon conversion may be settled in whole or in part with cash, but the proposal is designed in particular to change the accounting for "Instrument C," a type of convertible debt described in EITF 90-19.[1] Instrument C convertible debt is structured so that upon conversion the principal amount of the obligation is repaid in cash and the value related to the conversion feature (the conversion spread) is settled in shares. These instruments are currently accounted for in a manner similar to fully share-settled convertible instruments, but under current requirements, they are often less dilutive to earnings per share. When a convertible instrument is structured so that upon conversion the principal amount is repaid in cash and the conversion spread is settled in shares, earnings-per-share dilution is calculated by a method similar to the treasury-stock method. Therefore, unlike the if-converted method typically used to calculate earnings-per-share dilution for share-settled convertible instruments, Instrument C convertible debt affects diluted earnings per share only when the conversion feature is "in the money."[2] As in the case of ordinary convertible debt, these instruments may be structured so that no separate value is attributed to the conversion feature at issuance and the instrument is subsequently accounted for as debt on an amortized cost basis.[3]

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[1] EITF Issue No. 90-19, Convertible Bonds with Issuer Option to Settle for Cash upon Conversion, available at www.fasb.org.

[2] FASB Statement No. 128, Earnings per Share, February 1997, and EITF Issue No. 04-8, The Effect of Contingently Convertible Instruments on Diluted Earnings per Share, both available at www.fasb.org; and EITF Topic No. D-72, Effect of Contracts that May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share.

[3] APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, March 1969; EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock; EITF Issue No. 01-6, The Meaning of "Indexed to a Company's Own Stock"; and FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, all but Opinion 14 available at www.fasb.org.

The FASB believes new guidance is necessary because under current requirements the value of the conversion feature at issuance is not captured as a borrowing cost (i.e., it does not increase interest expense) and its full possible dilutive effect is not included in the denominator of earnings-per-share calculations. The coming proposal would remedy this situation by requiring all cash-settleable convertibles to be separated into their debt and equity components at issuance. The value assigned to the bond liability would be the estimated fair value, as of the issuance date, of a similar bond without the conversion feature, and the difference between the proceeds for the convertible debt and the amount reflected as a bond liability would be recorded as additional paid-in capital. As a result, the debt would be recorded at a discount reflecting its below market coupon interest rate. The debt would subsequently be accreted to its par value over its expected life, with a rate of interest being reflected on the income statement that reflects the market rate at issuance.

The guidance in the coming proposal is not expected to affect evaluations of whether embedded conversion features are derivatives under Statement 133. In all circumstances, issuers would have to determine whether the conversion option represents a derivative liability, rather than an equity feature, before considering the application of the coming Staff Position to the convertible instrument. If the conversion option is a derivative liability, the proposed guidance would not apply.

An Example

The following example illustrates the differences between accounting for fully share-settled convertible debt and partially cash-settled convertible debt under both current and soon-to-be proposed accounting requirements.

ABC issues convertible debt at a par value of $1,000 on January 1, 20X8. The conversion feature allows the investor to convert the debt in exchange for 50 shares of ABC common stock at the instrument's maturity in 5 years. At that time, the investor may choose to receive either the par value of the debt of $1,000 or to convert the debt for the value of 50 shares. If the investor exercises the conversion option, ABC will pay $1,000 of the conversion value in cash and the remaining value in shares (i.e., a portion of the 50-share notional value will be settled in cash upon conversion). Assume that the conversion feature is not a derivative under Statement 133, that ABC's stock price was $20 at issuance, that the instrument is not puttable or callable, and that tax effects are ignored.

The debt carries a coupon interest rate of 2 percent. The market interest rate for similar credit-quality nonconvertible debt is 8 percent. If ABC had issued 2 percent coupon-rate debt without the conversion feature, it would have received proceeds of $750 from investors.

ABC reports income of $220 for 20X8 before reflecting interest cost on the debt. The company's average stock price was $25 in 20X8, and it had 300 common shares outstanding throughout the year. There are no other potentially dilutive securities outstanding during the period.

Net Income and Diluted EPS under Current Accounting Requirements. ABC would report $200 of net income after deducting coupon interest of $20 on the debt. Because the debt principal must always be paid in cash, the if-converted method is not applied in calculating diluted earnings per share. Instead, because the conversion feature is in the money during 20X8, 10 additional shares ($250 additional value based on average stock prices / $25 average stock price) are included in diluted earnings per share, and the company reports diluted earnings per share of $0.65 per share ($200 of net income / 310 shares including the conversion spread value).

In contrast, if ABC had issued similar share-settled convertible debt, diluted earnings per share would have been $0.63 per share ($220 of net income because the interest is added back under the if-converted method / 350 shares assuming conversion of 50 shares at beginning of period).

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Net Income and Diluted EPS under Soon-to-be Proposed Requirements. ABC would initially record the carrying amount of the debt as $750 (principal of $1,000 and debt discount of $250). The conversion option would be reported as a $250 increase in paid-in capital. ABC would therefore report net income of $160 for 20X8 after deducting interest at 8 percent of $60 (coupon interest of $20 plus amortization of the discount on the debt of $40). At the end of 20X8, the carrying amount of the debt would be $790. The company would report diluted earnings per share of $0.52 ($160 of net income / 310 outstanding shares including the conversion spread). Under the coming proposal, the value of the conversion feature would be included in net income through the amortization of the debt discount to interest expense and would be reflected both in basic and diluted earnings per share.

In contrast, if ABC had issued share-settled convertible debt, diluted earnings per share would have been $0.63 per share, computed in the same manner as under current requirements described above.

Comment Period, Effective Date, and Transition

The expected proposal would require retrospective application for the first annual reporting period beginning after December 15, 2007 (January 1, 2008 for calendar-year companies). The final Staff Position, assuming no changes, would therefore require the new separation model for cash-settleable convertible instruments to be applied to both new and existing instruments in current and comparative periods. Comments will be due within the 45-day period beginning when the proposal is posted to the FASB website.

The descriptive and summary statements in this presentation are not intended to be a substitute for the yet-to-be-issued proposed FASB Staff Position or any other applicable or potential accounting literature or SEC regulations. Companies applying GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

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