



New FASB Accounting Rules on Convertible Debt

Issuers contemplating a financing should take note of new accounting guidance affecting certain convertible securities. Cash-settled convertible bonds have been a popular means of financing for issuers because the issuance of these bonds had a less dilutive effect on earnings per share than did the issuance of other securities. However, in May 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (“FSP”) APB 14-1,¹ which requires issuers to separately account for the liability and equity components of convertible debt instruments that may be settled partially or wholly in cash. The FSP will apply to financial statements for fiscal years beginning after December 15, 2008 and interim periods within those years. The FSP also will apply retrospectively for previously existing cash-settled convertible debt instruments, but it will not apply to instruments previously issued but that are not outstanding during any financial period presented. As we discuss below, application of this accounting standard may cause issuers to favor other securities over cash-settled convertible debt instruments, may motivate issuers and financial intermediaries to structure convertible securities differently, and may serve as a catalyst for restructuring existing transactions.

Scope

The FSP applies to convertible debt that may be partially or wholly cash-settled upon conversion and to convertible preferred shares that are mandatorily redeemable financial instruments classified as liabilities under FASB Statement No. 150. However, the FSP does not apply to convertible debt that (1) must be settled entirely in shares, (2) requires or allows cash settlement only in certain instances where the holder of the underlying shares would also receive the same form of consideration for its underlying shares or (3) only permits cash settlement for fractional shares that would otherwise be delivered upon conversion. The FSP also does not affect instruments for which the embedded conversion must be separately accounted for as a derivative. An issuer initially must evaluate whether the conversion option is a derivative liability or an equity feature. If it is the former, then the FSP does not apply.

Recognition and Initial Measurement

Under the new rules, an issuer must separately account for the liability and equity components of a convertible debt security. The issuer must value the liability component by measuring the fair value of a similar straight (nonconvertible) debt security. If the convertible debt security contains additional “substantive” embedded features, such as put and call options, the issuer must take these into account in assessing fair value. The issuer may disregard a non-substantive feature, or one the exercise of which is improbable.

An issuer must compute the carrying amount of the equity component of the convertible instrument by deducting the value of the liability component from the initial proceeds received at issuance. The equity component should

¹ The adopting release may be found at: http://www.fasb.org/pdf/fsp_apb14-1.pdf.

be recorded as additional paid-in capital on the issuer's balance sheet. The issuer then must allocate transaction costs proportionately between the liability and equity components. This new bifurcated approach may result in the liability component having a temporary basis difference for income tax purposes. The FSP requires that this difference be recorded as an adjustment to additional paid-in capital.

This new accounting approach draws some parallels with current tax rules applicable to convertible instruments. Indeed, as a response to objections that issuers may not be able to comply with the new bifurcation rules, the FSP mentions that issuers already may be required to determine their nonconvertible borrowing rate to adequately support their income tax positions. For example, certain convertible debt instruments containing contingent interest provisions are characterized, for tax purposes, as contingent debt obligations. An issuer of a contingent debt obligation generally is required to compute its nonconvertible borrowing rate and is permitted an income tax deduction based on that rate. In addition, many issuers of other convertible debt securities acquire call options on their own stock concurrent with the issuance of the securities (sometimes as part of a call spread). Under those circumstances, the convertible debt security and the call options may be integrated for tax purposes, resulting, the FSP claims, in an overall tax deduction that is similar to the issuers' nonconvertible debt borrowing rates.

Subsequent Measurement and Derecognition

An issuer must amortize over the expected life of the debt security, using the interest method, the excess of the initial proceeds over the initial fair value of the debt component (referred to as the debt discount) and issuance costs. This means that in subsequent periods the issuer must recognize non-cash interest expense in addition to the cash payments made on the debt security. Because the debt discount is amortized, the amount of interest expense reported in each subsequent period will be greater than an issuer would have previously recognized under GAAP. In determining the expected life of the debt security, the issuer should ignore the conversion option and should consider other substantive prepayment features to ensure that the assumptions used in the amortization calculation are the same as those used in the valuation calculation. As long as the equity component qualifies as equity under GAAP, subsequent measurement is unnecessary.

If an instrument is (1) converted, (2) paid off, or (3) modified or exchanged in such a way that qualifies as extinguishment under GAAP (referred to as derecognition), the issuer must allocate the consideration to (x) the extinguishment of the liability component and (y) the reacquisition of the equity component.

Modifications and Exchanges

If an issuer modifies or exchanges a convertible debt security (other than as described above), it must still apply the FSP and account for the liability and equity component of the security separately. An issuer would be required to reassess the expected life of the convertible debt security and the new effective interest rate according to GAAP and continue to amortize the debt discount over the new expected life of the instrument.

Given the new accounting treatment, an issuer may look to modify the terms of existing convertible debt securities to avoid the higher interest expenses. The FSP would not apply to the modified security prospectively, however, if the modification occurred before the FSP's effective date, the issuer would have to apply the FSP retrospectively up to the modification date.

Disclosures

The FSP requires that issuers provide additional disclosures regarding convertible debt securities, so that investors will have a better understanding of the terms of any convertible debt securities. The chart below outlines the required disclosures.

As of Each Balance Sheet Date:	As of the Most Recent Balance Sheet Date:
<ul style="list-style-type: none"> Principal amount of the liability component, its unamortized discount and its net carrying amount Carrying amount of the equity component 	<ul style="list-style-type: none"> Remaining period over which any discount on the liability component will be amortized Conversion price and amount of shares on which aggregate consideration deliverable upon conversion is determined
<p>Income Statement Period:</p> <ul style="list-style-type: none"> Effective interest rate on the liability component for the period Amount of interest cost recognized for the period relating to both the contractual interest coupon and amortization of the discount on the liability component 	<ul style="list-style-type: none"> Amount by which the instrument's if-converted value exceeds its principal amount, regardless of whether the instrument is currently convertible (for public companies only) Information about derivative transactions entered into in connection with the issuance of the instrument, including the terms, how those transactions relate to the instrument, the amount of shares underlying the transactions and the reasons for entering into those transactions

Impact

Application of the FSP will have the primary effect of making certain convertible debt instruments less attractive financing options for issuers. The FSP closes a perceived loophole that permitted an issuer to account for a convertible debt instrument only as debt on its financial statements. Now, an issuer will be required to recognize non-cash interest expense that reflects the amounts the issuer would have had to pay if the instrument did not have the conversion option. This, in turn, results in increased interest expense that lowers an issuer's earnings per share. The FSP has eliminated the favorable accounting treatment that helped make convertible debt instruments attractive.

The FSP also may affect stock prices and perceptions regarding an issuer's leverage. In principle, the new accounting should not affect an issuer's stock price because the fundamental economics underlying the convertible debt security remain unchanged. If, however, investors perceive the accounting changes as reflecting higher borrowing costs for the issuer, there may be downward price pressure on the issuer's securities.

Prior to the FSP, an issuer would recognize as debt on its balance sheet the full amount of the initial proceeds of issuance. Because the FSP requires bifurcation, the actual principal amount of debt that an issuer is carrying may be understated on its balance sheet. Under the FSP, issuers only recognize as debt the liability component of the convertible debt security.

Contacts

Corporate and Securities Law

Anna Pinedo
(212) 468-8179
apinedo@mofocom

Mara Goldsmith
(212) 336-8472
mgoldsmith@mofocom

Anna Lau
(212) 336-4095
alau@mofocom

Federal Tax Law

Shamir Merali
(212) 336-4149
smerali@mofocom

About Morrison & Foerster

With more than 1000 lawyers in 17 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China.

For more information, visit www.mofocom.

© 2008 Morrison & Foerster LLP. All rights reserved.