IASB/FASB Meeting February 2010	IASB agenda reference	**15C**
	FASB memo reference	**88**

Project	**Financial instruments with characteristics of equity**
Topic	**Convertible debt**

Introduction

1. In the 4-series approaches, convertible debt would be classified as a liability in its entirety because the holder has a cash settlement feature. At least one board member has expressed a preference for requiring convertible debt to be separated into liability and equity components. At the February meeting, we will ask the boards to decide how convertible debt should be classified.

Analysis

2. Most people view a convertible debt as having an equity component similar to a freestanding call option. However, the equity component does not have a value comparable to a freestanding option. The value of the equity component is determined by valuing a hypothetical debt component first and subtracting that amount from the total value of the bond. The component is classified as equity because it is viewed as similar to a physically settled written call option.

3. The non-bond component of a convertible bond does not have a value comparable to a freestanding call option. The equity component is more complicated than the usual call option if it is actually a written call option. It has a variable strike price

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equal to the fair value of the convertible bond (principal plus the coupon rate of interest). In fact, the strike price is not only variable; it depends on the value of the bond as a whole, which is a complicated and circular notion.

4. One reason for requiring bifurcation is to require that interest expense comparable to a freestanding debt instrument be reported. However, this project is unlikely to achieve that objective for all convertible debt. If the separation requirements were closely tied to the specified-for-specified criteria, it would be too easy to circumvent. An entity that does not want to separate convertible debt could include some variability in the number of shares to be issued to fail the specified-for-specified requirement.

5. For the following other reasons, separating convertible debt instead of classifying it as a liability in its entirety seems to run counter to the objectives in this project:

   (a) Conversion of convertible debt is not an exchange of a fixed amount of a financial asset for a fixed number of shares for at least three reasons:

      (1) Although the principal amount is fixed, its value is not

      (2) To the issuer, the bond is not a financial asset

      (3) The entity giving up the bond principal also is giving up its right to receive interest, the value of which varies according to market interest rates and the undiscounted amount of which changes after each interest payment is made.

   (b) It may raise more issues than it resolves. Some questions about convertible debt that the IASB staff has received involve how to account for bonds with the following characteristics:

      (1) The principal amounts are denominated in foreign currencies.

      (2) The bonds are issued by a subsidiary and convertible into the parent's shares, especially when the two entities have different functional currencies.

      (3) The provisions allow or require the holder to convert upon a change in control and adjust the number of shares to

compensate for the time value lost by converting earlier than the holder would otherwise have done.

(4) There are changes in the number of shares to be received to compensate for dilution or anti-dilution because of specified events such as stock splits, stock dividends, reverse splits, rights issuances, or share issuances.

6. Because no convertible debt is really an exchange of a fixed amount of a financial asset for a fixed number of shares, it may be very difficult to describe which convertible debt instruments should be separated and why.

7. If the boards choose to require bifurcation of convertible debt, we strongly recommend that the requirement apply to all convertible debt regardless of the price and terms. The debt component of the simplest form of convertible debt would be a bond with the same maturity date as the actual convertible debt, and the interest rate would be the rate of the nonconvertible bond of comparable credit quality from the same issuer. The remainder of the value of the convertible debt would be allocated to an equity component.

8. Unfortunately, that short description does not deal with any of the issues related to accounting for the settlement of the convertible debt whether it is converted or settled with cash. The entry is not likely to balance in either case, and so the boards will need to decide where the plug will go. (Equity, net income, and other comprehensive income seem to be the available choices.) In addition, convertible debt is often callable and may contain other complicating features as well.

9. If the boards decide to require bifurcation, they will have to consider a number of issues related to accounting for the components at a future meeting. A significant amount of time was spent on the issue during the FASB's consideration of the ownership-settlement approach, and we will have to resurrect that material. Because it is voluminous and complicated, we have not burdened you with it for this meeting.

10. The problem of not recognizing any significant interest or other expense could be solved much more easily and simply in one of three ways:

(a) Require measurement at fair value through profit and loss/net income (at least in the United States, a significant percentage of convertible debt would have a quoted price)

(b) Require accrual of interest on the entire "principal" amount at a market rate of interest

(c) Measure the stock issued upon conversion at fair value with any gain or loss in profit and loss/net income.

Staff Recommendation

11. We recommend that convertible debt not be separated but instead measured at fair value through profit and loss/net income.

Question for the Boards
1. Should convertible debt be separated into liability and equity components or classified as one single liability?