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**FASB DECIDES WHETHER CERTAIN CONVERSION FEATURES IN
FOREIGN CURRENCY DENOMINATED CONVERTIBLE BONDS ARE DUAL
INDEXED**

Overview

The Financial Accounting Standards Board ("FASB" or "Board") recently discussed whether conversion options embedded in convertible debt instruments (where the principal of the debt is denominated in a currency different than the listing currency of the underlying stock) are considered dual indexed for the purposes of applying FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133").

The discussions focused on whether the embedded conversion options are indexed to both an entity's own stock price and foreign currency exchange rates.

SFG Observation: If a conversion option is dual indexed (indexed to something in addition to an entity's own stock), it would not meet the SFAS 133, paragraph 11(a) scope exception. As a result, if the embedded conversion option meets all of the conditions to be a derivative, the issuer would have to separately account for the option at fair value under SFAS 133.

The 11(a) scope exception applies to both embedded and freestanding contracts that relate to an issuer's own equity. The guidance provided by the

Board applies equally to conversion options in debt hosts and freestanding instruments such as warrants.

The Board concluded that under certain scenarios, the conversion option would not meet the scope exception for an equity instrument and must be bifurcated from the debt contract.

SFG Observation: If a conversion option must be bifurcated from the debt host contract, the entire option must be bifurcated as a single instrument. The embedded derivative cannot be allocated into separate risks such as foreign exchange and equity risk.

The valuation of the written option by the issuer must include foreign exchange rates, volatility of the issuer's share price, and interest rates.

Background

Issuers typically structure the issuance of convertible debt and other equity instruments to ensure that no component of the instrument would be considered an embedded derivative that is required to be bifurcated and marked to market (accounted for separately with changes in value recognized in earnings). SFAS 133 provides a scope exception targeted at such instruments. Paragraph 11(a) states:

"Notwithstanding the conditions of paragraphs 6-10, the reporting entity shall *not* consider the following contracts to be derivative instruments for purposes of this Statement:

(a) Contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position"

These two criteria have been applied narrowly and the application has been discussed in several EITF Issues:

1. EITF 90-19 *Convertible Bonds with Issuer Option to Settle for Cash Upon Conversion*,
2. EITF 00-19 *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, and
3. EITF 01-6 *The Meaning of "Indexed to a Company's Own Stock*.

The scope exception only applies to an instrument that is *solely* indexed to the issuer's stock (as opposed to being indexed to an issuer's stock and other market variables---"dual indexed"). There has been diversity in practice in

applying criterion (1) to an instrument that contains elements of foreign exchange risk.

SFG Observation: It is important to note that the 11(a) scope exception is only applicable to the issuer of the instrument.

The investor in convertible debt, warrants, or similar instruments does not have a similar scope exception. Investors generally are required to bifurcate the conversion option from the debt instrument or account for a warrant as a freestanding derivative when the embedded option or warrant meets the definition of a derivative. As a result, the accounting model often results in different treatment for an investor and issuer.

Board Meeting Discussion

The Board discussed two scenarios under which there has been diversity in practice regarding whether the embedded conversion option was considered dual indexed.

Scenario 1

Company issues convertible debt denominated in a currency different than the issuer's functional currency. The instrument is convertible into the issuer's common stock at the option of the investor. The underlying common stock is listed and traded on exchange with the same currency as the issuer's functional currency.

An example of this scenario would be a US dollar functional company that issues Euro denominated convertible debt that is convertible into shares only traded on a US stock exchange.

The Board concluded that the embedded conversion option does not meet the 11(a) scope exception. The consideration received for the exchange of shares for the outstanding debt instrument is variable.

The fair value of this debt instrument surrendered to exercise the conversion will vary due to changes in foreign currency exchange rates. Therefore the exercise/conversion price changes simply due to changes in foreign currency exchange rates. The Board concluded (in a 4 to 3 vote) that the conversion option was not solely indexed to the entity's own stock. As a result, if the conversion option meets the definition of a derivative, it must be separately accounted for under SFAS 133 at fair value.

SFG Observation: The FASB has acknowledged that all convertible bonds have some elements of dual indexing as the fair value of the consideration received by the issuer (the reacquired host debt instrument) will be affected by interest rates (if a fixed rate bond) and credit spreads.

The majority of the Board concluded that the foreign currency features should be evaluated differently than interest rate features (see Alternative View below). We understand the Securities and Exchange Commission shares this view.

Alternate View

Three Board members supported the exploration of an alternative perspective on Scenario 1 when evaluating whether the conversion option would be considered dual indexed.

These Board members thought that the effects of the foreign exchange risk could be considered a component of the debt host similar to interest rate and credit risk, and not part of the conversion option.

If the foreign exchange features were considered part of the debt host, the effects would be captured as part of the accounting for the host contract under *FASB Statement No. 52, Foreign Currency Translation* ("SFAS 52"). Paragraph 15 of SFAS 133 explicitly states that such foreign exchange risk is not considered a derivative.

SFG Observation: It was acknowledged that the alternative view would lead to differences in the accounting model for a similar derivative that was embedded in a host contract and a freestanding derivative.

Scenario 2

A Company issues convertible debt denominated in its functional currency that is convertible into the issuer's common stock that is only traded on a foreign stock exchange.

An example of this scenario would be a USD functional company that issues USD denominated convertible debt that is convertible into shares only traded in Euros on a European stock exchange.

The Board unanimously agreed that under this scenario, the conversion option did meet the 11(a) scope exception and would not be considered dual indexed. The option requires an entity to issue a fixed number of shares of its own equity. The fact that the shares are traded in a currency other than its

functional currency would not make the shares indexed to an underlying other than the issuer's equity.

SFG Observation: In Scenario 2, the fair value of the consideration received by the issuer upon conversion is not sensitive to foreign currency rate fluctuations as measured in the issuer's functional currency.

The analysis is consistent with the guidance in SFAS 52 which requires equity securities to be translated and reflected at historical exchange rates.

The primary distinction between Scenario 1 and Scenario 2 which drives the difference in accounting treatment is the value of the consideration received by the Company in compensation for the exercise of the conversion option. In Scenario 1, the value of the debt surrendered (as measured in the functional currency of the issuer) fluctuates as foreign exchange rates change. In Scenario 2, since the debt is denominated in the functional currency of the issuer, this does not occur. If the conversion price varies or the issuer is obligated to issue a variable number of shares due to changes in an underlying (FX rates), the conversion option is considered to be dual indexed.

Next Steps

The Board released DIG Issue C21 *Scope Exceptions: Whether Options (Including Embedded Conversion Options) Are Indexed to both an Entity's Own Stock and Currency Exchange Rates* with a comment period ending May 24, 2007. The effective date of the final version will be the annual period beginning after the guidance is posted to the FASB website.

Transition Provisions

The proposed transition provisions are as follows:

If a conversion option is required to be bifurcated and previously had not been bifurcated, the debt host should be accounted for at its accreted value as if the option had been bifurcated at issuance and the conversion option should be carried at fair value.

The difference between (a) the carrying amount of the debt plus the fair value of the conversion option after adoption and (b) the carrying amount of the debt prior to adoption should be reflected as a cumulative effect adjustment to opening retained earnings.

If a conversion option had been bifurcated and bifurcation is no longer required, the carrying amount of the liability for the conversion option should be

reclassified to equity and the discount on the debt should continue to be accreted.

SFG Observation: We understand that the FASB has had discussions with the Securities and Exchange Commission regarding these transition provisions. Because the FASB is expected to propose cumulative effect transition provisions, we believe it is not intended that an issuer retrospectively restate due to the Board's decision.

If an issuer has reached a conclusion that is contrary to this Board decision and must file financial statements prior to the issuance of the final guidance, we believe the issuer should continue its previous accounting model for those securities that have been issued before the Board meeting.

The Company should consider the disclosure requirements of Staff Accounting Bulletin No. 74 'Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period' (SAB 74).

The disclosures should alert readers that the financial statements will be affected upon issuance of the final guidance.

Questions

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