

## Interpretation of the Emerging Accounting Issues Working Group

### INT 00-08: EITF 98-5: Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios

#### ISSUE NULLIFIED BY SSAP NO. 15

#### INT 00-08 Dates Discussed

March 13, 2000; June 12, 2000; September 11, 2000

#### INT 00-08 References

*SSAP No. 15—Debt and Holding Company Obligations* (SSAP No. 15)

#### INT 00-08 Issue

1. Entities may issue convertible debt securities and convertible preferred stock with a nondetachable conversion feature that is in-the-money at the commitment date (a “beneficial conversion feature”). Those securities may be convertible into common stock at the lower of a conversion rate fixed at the commitment date or a fixed discount to the market price of the common stock at the date of conversion. APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants* (APB No. 14) addresses an issuer's accounting for convertible debt with a nondetachable (embedded) conversion feature, the terms of which provide for (a) an initial conversion price that is greater than market value at the date of issuance and (b) a conversion price that does not decrease, except under antidilution protection. APB No. 14 does not explicitly address situations in which the embedded conversion feature is in-the-money at issuance, nor does it explicitly address convertible preferred stock.

2. Certain convertible securities may have a conversion price that is variable based on future events such as a subsequent round of financing at a price lower than the convertible securities' original conversion price, a liquidation or a change in control of the company, or an initial public offering at a share price lower than an agreed-upon amount. APB No. 14 also does not explicitly address situations in which the conversion terms are contingently adjustable.

3. This issue applies to convertible securities with beneficial conversion features that must be settled in stock and to those that give the issuer a choice of settling the obligation in either stock or cash. This Issue also applies to instruments with beneficial conversion features that are convertible into multiple instruments, for example, a convertible preferred stock that is convertible into common stock and detachable warrants. In addition, this Issue applies to instruments with conversion features that are not beneficial at the commitment date but that become beneficial upon the occurrence of a future event, such as an initial public offering.

4. The issues are:

- a. Issue 1—Whether embedded beneficial conversion features present in convertible securities should be valued separately at the commitment date
- b. Issue 2—If the answer to Issue 1 is to value beneficial conversion features separately, then how an embedded conversion feature should be recognized and measured

- c. Issue 3—How the issuance of convertible securities with beneficial conversion ratios that adjust based on the occurrence of specified future events should be accounted for.

#### **INT 00-08 Discussion**

5. The working group reached a consensus to reject the consensus positions reached in EITF 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios* (EITF 98-5) based upon a recommendation from the Invested Assets Working Group (IAWG). The IAWG reported that they had considered EITF 98-5 in the light of accounting guidance in the *SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities* and *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)*. While recognizing the conservatism reflected by requiring amortization of premium on a yield to worst basis, neither the members of IAWG nor members of interested persons expressed interest in revising this guidance. The IAWG is of the opinion that any revision to the current accounting guidance for the purpose of accommodating financial instruments within the scope of EITF 98-5, should recognize the equity-like nature of the premium over par or accreted value. IAWG is also of the opinion that full recognition of the equity-like nature of the premium should extend to accounting, reporting, asset valuation reserves, and risk based capital.

#### **INT 00-08 Status**

6. No further discussion is planned.