

## Interpretation of the Emerging Accounting Issues Working Group

### INT 02-05: Accounting for Zero Coupon Convertible Bonds

#### ISSUE NULLIFIED BY SSAP NO. 26

#### INT 02-05 Dates Discussed

March 18, 2002; June 9, 2002; September 10, 2002; December 8, 2002

#### INT 02-05 References

*SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities* (SSAP No. 26)

#### INT 02-05 Issue

1. There has been an increase in the purchasing of convertible bonds by insurers recently. The market of convertible bonds is going to extreme features and has forced an issue related to accounting for such securities. To help understand the potential issues on statutory accounting related to convertible bonds, it is best to start with GAAP to better understand the economics of the instrument.

2. For illustrations accompanying this interpretation, assume the following facts:

Type of Security	Commercial Convertible Bond
Par value	\$1,000,000
Annual coupon rate	5%
Maturity date	10 years from date of purchase
Convertible features	Convertible to 10,000 common shares of issuer
Strike Price	\$100 per share
Current Price	\$70 per share

#### Generally Accepted Accounting Practices (GAAP)

3. A convertible bond really consists of a bond and an embedded derivative in the form of a warrant. Under GAAP, the holder accounts for the two components separately. The bond and warrants are fair valued at date of purchase. The bond is typically classified as available for sell (AFS) or held to maturity (HTM) and the scientific method of amortization is used on any premium or discount. This amortization of the premium or discount produces a market yield when combined with the coupon rate. In addition, the available for sale is recorded at fair value with the unrealized gains and losses recorded as a component of equity in other comprehensive income. The warrant is fair valued at each reporting date and classified as trading with adjustments to fair value recorded through the income statement, as it is considered a derivative (no hedge).

4. For GAAP, assuming a purchase price was \$900,000 at 1/1/x1 and the fair value of the warrants was \$150,000 at 1/1/x1, the following entries would be recorded during the year:

<b>At 1/1/X1:</b>	
Purchase Price	\$900,000
Bond Fair Value	\$750,000
Yield	8.87%
Warrant Fair Value	\$150,000

<b>At 12/31/X1:</b>	
Bond Fair Value	\$780,000
Warrant Fair Value	\$200,000

<b>Entries 1/1/X1:</b>	
Bonds-AFS	\$750,000
Warrants-Trading	\$150,000
Cash	(\$900,000)

<b>Entries 12/31/X1:</b>	
Cash (coupon rate)	\$50,000
Bonds-AFS (amortization)	\$16,554
Investment income	(\$66,554)

*Record discount accretion and cash from coupon rate*

Bonds-AFS	13,446
Warrants-Trading	50,000
Unrealized gains-OCI	(13,446)
Realized gains	(50,000)

*Mark AFS and Trading to fair value*

### Statutory Accounting Practice (SAP)

5. Under statutory accounting (SSAP No. 26), a convertible bond is accounted for as a bond. Thus, it ignores the embedded instrument and places no value on it. For example, the following is how the above example would be accounted for:

<b>At 1/1/X1:</b>	
Purchase Price	\$900,000
Bond Value	\$900,000
Yield	6.3835%
Warrant Value	\$0

<b>Entries 1/1/X1:</b>	
Bonds-AFS	\$900,000
Cash	(\$900,000)

<b>Entries 12/31/X1:</b>	
Cash (coupon rate)	\$50,000
Bonds (amort)	\$7,451
Investment Income	(\$57,451)

*Record discount accretion and cash from coupon rate*

6. Notice that the computed yield decreased between GAAP and SAP. The difference is inherently the amortization of the warrant's fair value at the date of purchase to zero using the

scientific method. Thus, if the bond does reach the end of the ten years without conversion, this technique was correct because the value of the warrant was zero at the end of the 10-year term. If the value of the warrant was near zero any time prior to the end of the ten-year term, the Company in essence was able to defer the loss on the warrant and amortize it slowly into the income statement.

7. If the warrant increased in value and began to exceed the par value significantly but the company (since it is at the Company's option) decided not to exercise the conversion, then it has a security recorded at amortized cost in Schedule D as a bond when its characteristics more closely resemble an equity instrument.

#### When a Negative Yield Results

8. The following is another example of a convertible bond, but the coupon rate is zero and the purchase price is at a premium (above par value). Thus, the insurer purchased a \$1,000,000 zero coupon (which is typically purchased at a discount) convertible bond for \$1,150,000. Therefore, the warrants have significant value (so much so it more than offsets the implicit rate of the bond).

Par value	\$1,000,000
Coupon rate	0%
Maturity	10 years
<i>Convertible into 10,000 common shares of issuer</i>	

#### **At 1/1/X1:**

Purchase Price	\$1,150,000
Bond Value	\$1,150,000
Yield	-1.3879%
Warrant Value	-

#### **Entries 1/1/X1:**

Bonds	\$1,150,000
Cash	(\$1,150,000)

#### **Entries 12/31/X1:**

Cash (coupon rate)	-
Bonds (amort)	(15,961)
Interest Income	15,961

*Record discount accretion and cash from coupon rate*

9. The result is an overall negative yield. In essence, the amortization of value of the warrant at date of purchase exceeds the discount on the bonds.

10. The accounting issue is how to account for the premium paid on a zero coupon convertible bond that produce a negative yield as a result of the value of a warrant exceeding the bond discount (the above example). Fundamentally, is it amortized into income using a negative yield or written off at the date of purchase?

#### **INT 02-05 Discussion**

11. The working group reached a consensus that the premium paid for a zero coupon convertible bond shall be written off immediately so that a negative yield is not produced.

12. The working group reached a consensus that the full amount of the premium should be recorded as amortization within investment income on the date of purchase.

**INT 02-05 Status**

13. No further discussion is planned.