1969

Accounting for convertible debt and debt issued with stock purchase warrants; Opinions of the Accounting Principles Board 14; APB Opinion 14

American Institute of Certified Public Accountants. Accounting Principles Board

Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants

INTRODUCTION

1. Paragraphs 8 and 9 of APB Opinion No. 10[1] stated that a portion of the proceeds received for convertible debt or debt issued with stock purchase warrants is ordinarily attributable to the conversion feature or to the warrants and should therefore be accounted for as paid-in capital. Since the issuance of that Opinion, the Board has observed the experiences of issuers of these securities in applying those paragraphs. In addition, interested parties have expressed their views as to the nature of these securities and the problems of implementing the principles discussed in those paragraphs. The observations and views indicated that dealing with certain aspects of these securities, particularly convertible debentures, involved difficult problems which warranted further study. In December 1967, the Board, therefore, temporarily suspended the effectiveness of paragraphs 8 and 9 of APB Opinion No. 10 retroactively to their effective date and established specific requirements for earnings per share data to be included in income statements. (See paragraphs 11 through 15 of APB Opinion No. 12.)

[1] Effective for fiscal periods beginning after December 31, 1966.

Issued by the Accounting Principles Board of the American Institute of Certified Public Accountants

2. Since then the Board has reexamined the characteristics of convertible debt and debt issued with stock purchase warrants to determine whether the accounting called for by paragraphs 8 and 9 of APB Opinion No. 10 should be reinstated. This Opinion results from that study and sets forth the conclusions reached by the Board. Accordingly, this Opinion supersedes paragraphs 8 and 9 of APB Opinion No. 10 and paragraphs 11 through 15 of APB Opinion No. 12.

CONVERTIBLE DEBT

Discussion

3. Convertible debt securities discussed herein are those debt securities which are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price or have a value at issuance not significantly in excess of the face amount. The terms of such securities generally include (1) an interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater than the market value of the common stock at time of issuance, and (3) a conversion price which does not decrease except pursuant to antidilution provisions. In most cases such securities also are callable at the option of the issuer and are subordinated to nonconvertible debt.

4. Convertible debt may offer advantages to both the issuer and the purchaser. From the point of view of the issuer, convertible debt has a lower interest rate than does nonconvertible debt. Furthermore, the issuer of convertible debt securities, in planning its long-range financing, may view convertible debt as essentially a means of raising equity capital. Thus, if the market value of the underlying common stock increases sufficiently in the future, the issuer can force conversion of the convertible debt into common stock by calling the issue for redemption. Under these market conditions, the issuer can effectively terminate the conversion option and eliminate the debt. If the market value of the stock does not increase sufficiently to result in conversion of the debt, the issuer will have received the benefit of the cash proceeds to the scheduled maturity dates at a relatively low cash interest cost.

5. On the other hand, the purchaser obtains an option to receive either the face or redemption amount of the security or the number of common shares into which the security is convertible. If the market value of the underlying common stock increases above the conversion price, the purchaser (either through conversion or through holding the convertible debt containing the conversion option) benefits through appreciation. He may at that time require the issuance of the common stock at a price lower than the current market price. However, should the value of the underlying common stock not increase in the future, the purchaser has the protection of a debt security. Thus, in the absence of default by the issuer, he would receive the principal and interest if the conversion option is not exercised.

6. Differences of opinion exist as to whether convertible debt securities should be treated by the issuer solely as debt or whether the conversion option should receive separate accounting recognition at time of issuance. The views in favor of each of these two concepts are contained in the following paragraphs.

7. The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he foregoes the right to redemption, and vice versa.

8. Another reason advanced in favor of accounting for convertible debt solely as debt is that the valuation of the conversion option or the debt security without the conversion option presents various practical problems. In the absence of separate transferability, values are not established in the marketplace, and accordingly, the value assigned to each feature is necessarily subjective. A determination of the value of the conversion feature poses problems because of the uncertain duration of the

right to obtain the stock and the uncertainty as to the future value of the stock obtainable upon conversion. Furthermore, issuers often claim that a subjective valuation of a debt security without the conversion option but with identical other terms (which are usually less restrictive on the issuer and less protective of the holder than those of nonconvertible debt) is difficult because such a security could not be sold at a price which the issuer would regard as producing an acceptable cost of financing. Thus, when the attractiveness to investors of a convertible debt security rests largely on the anticipated increased value of the issuer's stock, the conversion feature may be of primary importance, with the debt feature regarded more as a hedge than as the principal investment objective. Many proponents of the single-element view believe that the practical problems of determining separate values for the debt and the conversion option should not be controlling for purposes of determining appropriate accounting but such problems should be given consideration, particularly if valid arguments exist for each of the two accounting concepts identified in paragraph 6.

9. The contrary view is that convertible debt possesses characteristics of both debt and equity and that separate accounting recognition should be given to the debt characteristics and to the conversion option at time of issuance. This view is based on the premise that there is an economic value inherent in the conversion feature or call on the stock and that the nature and value of this feature should be recognized for accounting purposes by the issuer. The conversion feature is not significantly different in nature from the call represented by an option or warrant, and sale of the call is a type of capital transaction. The fact that the conversion feature coexists with certain debt characteristics in a hybrid security and cannot be sold or transferred separately from these senior elements or from the debt instrument itself does not constitute a logical or compelling reason why the values of the two elements should not receive separate accounting recognition. Similar separate accounting recognition for disparate features of single instruments is reflected in, for example, the capitalization of long-term leases – involving the separation of the principal and interest elements – and in the allocation of

the purchase cost in a bulk acquisition between goodwill and other assets.

10. Holders of this view also believe that the fact that the eventual outcome of the option available to the purchaser of the convertible debt security cannot be determined at time of issuance is not relevant to the question of reflecting in the accounting records the distinguishable elements of the security at time of issuance. The conversion option has a value at time of issuance, and a portion of the proceeds should therefore be allocated to this element of the transaction. The remainder of the proceeds is attributable to the debt characteristics, and should be so recognized for accounting purposes.

11. Holders of this view also believe that the difficulties of implementation — which are claimed by some to justify or to support not recognizing the conversion option for accounting purposes — are not insurmountable and should not govern the conclusion. When convertible debt securities are issued, professional advisors are usually available to furnish estimates of values of the conversion option and of the debt characteristics, which values are sufficiently precise for the purpose of allocating the proceeds. If a nonconvertible debt security could not be sold at an acceptable price, the value of the conversion option is of such material significance that its accounting recognition, even on the basis of an estimate, is essential.

Opinion

12. The Board is of the opinion that no portion of the proceeds from the issuance of the types of convertible debt securities described in paragraph 3 should be accounted for as attributable to the conversion feature. In reaching this conclusion, the Board places greater weight on the inseparability of the debt and the conversion option (as described in paragraph 7) and less weight on practical difficulties.

DEBT WITH STOCK PURCHASE WARRANTS

Discussion

13. Unlike convertible debt, debt with detachable warrants to purchase stock is usually issued with the expectation that the debt will be repaid when it matures. The provisions of the debt agreement are usually more restrictive on the issuer and more protective of the investor than those for convertible debt. The terms of the warrants are influenced by the desire for a successful debt financing. Detachable warrants often trade separately from the debt instrument. Thus, the two elements of the security exist independently and may be treated as separate securities.

14. From the point of view of the issuer, the sale of a debt security with warrants results in a lower cash interest cost than would otherwise be possible or permits financing not otherwise practicable. The issuer usually cannot force the holders of the warrants to exercise them and purchase the stock. The issuer may, however, be required to issue shares of stock at some future date at a price lower than the market price existing at that time, as is true in the case of the conversion option of convertible debt. Under different conditions the warrants may expire without exercise. The outcome of the warrant feature thus cannot be determined at time of issuance. In either case the debt must generally be paid at maturity or earlier redemption date whether or not the warrants are exercised.

15. There is general agreement among accountants that the proceeds from the sale of debt with stock purchase warrants should be allocated to the two elements for accounting purposes. This agreement results from the separability of the debt and the warrants. The availability of objective values in many instances is also a factor. There is agreement that the allocation should be based on the relative fair values of the debt security without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants should be accounted for as paid-in capital. The remainder of the proceeds should be allocated to the debt security portion of the transaction. This usually results in issuing the debt security at a discount (or, occasionally, a reduced premium).

Opinion

16. The Board is of the opinion that the portion of the proceeds of debt securities issued with detachable stock purchase warrants which is allocable to the warrants should be accounted for as paid-in capital. The allocation should be based on the relative fair values of the two securities at time of issuance.[2] Any resulting discount or premium on the debt securities should be accounted for as such.[3] The same accounting treatment applies to issues of debt securities (issued with detachable warrants) which may be surrendered in settlement of the exercise price of the warrant. However, when stock purchase warrants are not detachable from the debt and the debt security must be surrendered in order to exercise the warrant, the two securities taken together are substantially equivalent to convertible debt and the accounting specified in paragraph 12 should apply.

17. When detachable warrants are issued in conjunction with debt as consideration in purchase transactions, the amounts attributable to each class of security issued should be determined separately, based on values at the time of issuance.[2] The debt discount or premium is obtained by comparing the value attributed to the debt securities with the face amount thereof.

OTHER TYPES OF DEBT SECURITIES

Opinion

18. The Board recognizes that it is not practicable in this Opinion to discuss all possible types of debt with conversion features, debt issued with stock purchase warrants, or debt securities with a combination of such features. Securities not explicitly discussed in this Opinion should be dealt with in accordance with the substance of the transaction. For example, when convertible debt is issued at a substantial premium, there is a presumption that such premium represents paid-in capital.

---

[2] The time of issuance generally is the date when agreement as to terms has been reached and announced, even though the agreement is subject to certain further actions, such as directors' or stockholders' approval.

[3] See Chapter 15 of ARB No. 43 (as amended by paragraph 19 of APB Opinion No. 6 and paragraph 17 of APB Opinion No. 9) and paragraphs 16 and 17 of APB Opinion No. 12.

EFFECTIVE DATE OF THIS OPINION

19. This Opinion is effective for fiscal periods beginning after December 31, 1966.[4] However, if a portion of the proceeds of a convertible debt issue covered by paragraph 12 was allocated to the conversion feature for periods beginning before January 1, 1969 that accounting may be continued with respect to such issues.

20. Material adjustments resulting from adoption of this Opinion which affect periods beginning prior to January 1, 1969 should be treated as prior period adjustments (see paragraphs 23 and 25 of APB Opinion No. 9).

The Opinion entitled "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants" was adopted by the assenting votes of fourteen members of the Board, of whom two, Messrs. Halvorson and Luper, assented with qualification. Messrs. Cummings, Davidson, Seidman and Weston dissented.

Mr. Halvorson assents to the publication of the Opinion, but dissents to paragraph 19 insofar as it requires the recommended accounting for detachable warrants to be made retroactive to January 1, 1967, and also dissents to paragraph 12 because he believes that, as a matter of principle, there are circumstances under which an issuer should be permitted, or even required, to account for a part of the proceeds of convertible debt as being attributable to the conversion feature.

Mr. Luper assents to the issuance of this Opinion but dissents to paragraph 19 which makes this Opinion effective for fiscal periods beginning after December 31, 1966. He believes that it is unsound for the Board to require that an Opinion be applied retroactively because such requirement causes a condition of instability in financial reporting standards.

Messrs. Cummings, Davidson, Seidman, and Weston dissent from the conclusion set forth in paragraph 12 of this Opinion,

---

[4] This was the effective date of paragraphs 8 and 9 of APB Opinion No. 10 which were temporarily suspended by paragraphs 11-15 of APB Opinion No. 12. The latter Opinion stated that the Board might decide to have the Opinion resolving this question apply retroactively to fiscal periods beginning after December 31, 1966.

for the reasons set forth in paragraphs 9 through 11. They believe that, by ignoring the value of the conversion privilege and instead using as a measure solely the coupon rate of interest, the Opinion specifies an accounting treatment which does not reflect the true interest cost. The resulting error can be demonstrated by comparing the simultaneous sale of debt securities by two issuers—one with a prime credit rating, so that it can obtain financing by means of non-convertible debt; the other with an inferior credit rating, so that it can obtain financing at an acceptable rate only by means of a conversion option added to its debt. The coupon rate of interest on the debt of the prime rated issuer may be the same as, or higher than, the rate on the convertible debt of the other issuer. To conclude under these conditions, as the Opinion does, that the cost of this financing for the prime rated issuer is equal to or greater than that of the inferior rated issuer is to belie economic reality. Furthermore, while the debt obligation and the conversion feature coexist in a hybrid instrument, such fact is not a logical reason for failing to account separately for their individual values.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures from Opinions of Accounting Principles Board, *October, 1964) provides that:*

a. *"Generally accepted accounting principles" are those principles which have substantial authoritative support.*

b. *Opinions of the Accounting Principles Board constitute "substantial authoritative support".*

c. *"Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.*

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

Accounting Principles Board (1969)

LeRoy Layton
Chairman
Marshall S. Armstrong
Kenneth S. Axelson
Donald J. Bevis
Milton M. Broeker
George R. Catlett
Joseph P. Cummings
Sidney Davidson
Philip L. Defliese
Newman T. Halvorson
Emmett S. Harrington
Charles B. Hellerson
Charles T. Horngren
Louis M. Kessler
Oral L. Luper
J. S. Seidman
George C. Watt
Frank T. Weston