ISDA

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
United States of America
Telephone: 1 (212) 901-6000
Facsimile: 1 (212) 901-6001
email: isda@isda.org
website: www.isda.org

October 15, 2007

Mr. Russell G. Golden
Director, TA&I – FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position APB 14-a

Dear Mr. Golden:

The International Swaps and Derivatives Association ("ISDA") appreciates the opportunity to comment on the proposed FASB Staff Position APB 14-a, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (the "Proposed FSP"). ISDA members represent leading participants in the privately negotiated derivatives industry. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments.

In summary, ISDA does not support the proposed principle that requires separating the conversion option from a convertible debt instrument solely because it may be settled in cash (including partial cash settlement) upon conversion. We believe that, despite the difference in the form of consideration issued upon conversion of debt within the scope of the Proposed FSP, the economics of substantially all convertible debt instruments issued in the public markets are the same. Accordingly, we believe that the accounting for convertible debt instruments that settle in a fixed number of shares as well as those that permit or require the issuer to settle a portion of the if-converted value in cash (upon conversion) should be accounted for in the same manner.

ISDA also does not agree with the methodology prescribed by the FASB for separating the conversion option from a convertible debt instrument within the scope of the Proposed FSP. We believe that the methodology for separating the debt and equity components, which requires the issuer to disregard the terms of the embedded conversion option when determining the expected life and fair value of the debt component, is inconsistent with the way market participants price convertible bonds. Invariably this separation methodology will increase the complexity and judgment required to properly apply the Proposed FSP's provisions.

Lastly, we do not support the FASB's decision to separately address this matter by issuing additional guidance through a staff position, as doing so will only introduce complexity in financial reporting and erode comparability among issuers of convertible debt with similar, if not identical, economics. The Proposed FSP also raises questions regarding other related accounting issues, such as modifications/extinguishments and induced conversions, which are not being addressed by this guidance. Additionally, the guidance to be codified by the Proposed FSP will invariably intersect with the FASB's decisions made in its liabilities and equity project and the consensuses reached in other initiatives to address diversity in practice for these types of instruments (for example, EITF Issue 07-5). Accordingly, we strongly encourage the FASB to postpone issuing the Proposed FSP and address the accounting for instruments with features of liabilities and equity in a more comprehensive manner.

Should the FASB decide to issue this guidance as proposed, we strongly recommend that the effective date be delayed at least one year because of the significant impact the Proposed FSP's provisions could have on issuers' debt covenants (for example, interest coverage ratios that are based on GAAP interest expense). We believe that issuers may need additional time not only because the guidance is being issued close to the end of the calendar year (an extremely busy time for many preparers) but also to amend the terms of these instruments to avoid technical default for failing to meet covenants. Also, given the recent developments in the credit markets, we believe that many issuers may be at a disadvantage in effectively consummating any significant modification to the terms of their debt, including amendments to financial covenants.

We hope you find ISDA's comments informative and beneficial. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned or Hee Lee, ISDA's external accounting adviser, at 212-773-8605.

Sincerely,

Laurin Smith

Laurin Smith
J.P. Morgan Chase & Co.
Chair, Accounting Policy Committee
International Swaps and Derivatives Association
212.648.0909

<u>Separation Criteria</u>

1. ISDA does not agree with the FASB's conclusion that convertible debt instruments that may be settled in cash upon conversion are not within the scope of paragraph 12 of APB 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. Specifically, we disagree with the FASB's basis for requiring issuers to separate the liability and equity components of instruments within the scope of the Proposed FSP, which is that such instruments are economically akin to debt issued with detachable warrants because the principal of the debt is always returned to the holder (i.e., the components are mutually exclusive). Assuming the issuer is a going concern, a holder has two contractual settlement alternatives; the holder can either redeem the instrument (either prior to or in connection with maturity) for the principal amount, or the holder can convert the instrument. The holder cannot settle the debt and equity components separately and at different times. The settlement alternatives for instruments within the scope of the Proposed FSP are economically no different than those of convertible debt instruments that require settlement in shares upon conversion. Thus, we do not agree that a different recognition model should be applied to instruments that merely permit their settlement in cash upon conversion.

   Additionally, ISDA does not agree with the methodology prescribed by the FASB for separating the conversion option from the convertible debt instrument within the scope of the Proposed FSP. The methodology prescribed by the Proposed FSP for separating the debt and equity components of the instrument, which requires the issuer to disregard the terms of the embedded conversion option when determining the expected life and fair value of the liability component, is inconsistent with the manner in which market participants price convertible bonds. Thus, requiring issuers of convertible debt to record their nonconvertible debt borrowing costs without reflecting the impact of the inseparable equity component is a fundamental flaw because neither the equity nor the interest aspects are considered in isolation by market participants. We therefore do not believe the separation methodology prescribed by the FSP entirely supports the stated objectives, which is to account for convertible debt instruments based on their substance.

<u>Transition</u>

2. ISDA finds the retrospective transition provisions of the Proposed FSP punitive given that issuers of convertible debt instruments whose terms permit or require cash settlement upon conversion have been following the authoritative accounting guidance prescribed by the EITF for these instruments with little or no diversity in practice. We therefore strongly recommend that the FASB not require application of the Proposed FSP's provisions to the following instruments:

   – Instruments no longer outstanding at the effective date,

   – Instruments that were historically included in diluted earnings-per-share using the if-converted method and for which an irrevocable election is made prior to the effective date to gross share settle such instruments upon conversion,

- Instruments whose terms are modified by the effective date to only permit gross share settlement upon conversion (except in the circumstances described in paragraph 7 of the Proposed FSP).

ISDA does not believe that requiring retrospective application of the FSP's guidance (restatement) to the aforementioned scenarios improves financial reporting or increases the usefulness of the financial statements. Comparability of financial statements will not be improved since the accounting guidance for the instruments within the scope of the Proposed FSP was being applied consistently with little to no diversity in practice.

We also strongly recommend that the effective date for all other convertible debt instruments not described above that are outstanding at the effective date be delayed for at least a year because of the significant impact the Proposed FSP's provisions could have on issuers' debt covenants (for example, interest coverage ratios that are based on GAAP interest expense). Issuers may need additional time to modify the terms of these instruments to avoid technical default for failing to meet financial covenants. Based on the proposed effective date, many of those issuers will likely be approaching the same creditors at the same time to request such modifications. Given the recent developments in the credit markets, issuers approaching creditors en masse will be at an economic disadvantage in effectively consummating any significant modification to the terms of their debt, including amendments to financial covenants. In addition, the FASB should be cognizant that if this guidance is issued and effective as proposed, preparers will be required to address the requirements of the Proposed FSP at a time when they are otherwise dealing with external reporting and other year-end responsibilities. The basis for our recommendation is also supported by other FASB guidance that has been issued with delayed transition periods, including EITF 04-5.

Furthermore, the guidance to be codified by the Proposed FSP will invariably intersect with the FASB's decisions made in its liabilities and equity project and the consensuses reached in other initiatives to address diversity in practice for these types of instruments (for example, EITF Issue 07-5). Accordingly, we strongly encourage the FASB to postpone issuing the Proposed FSP and address the accounting for instruments with features of liabilities and equity in a more comprehensive manner in order to avoid the cost and complexity of multiple transitions.

Other

3. Paragraph B15 of the Basis for Conclusions prohibits the issuer of a convertible debt instrument that was within the scope of the Proposed FSP at issuance from re-combining the separately recognized components of the instrument if its terms have been modified such that the instrument no longer permits or requires settlement of its conversion in cash unless extinguishment accounting is required pursuant to EITFs 06-6 and 96-19. The Board cited the consistency with the consensus reached in EITF Issue 06-7, which requires convertible debt instruments that no longer require bifurcation of an embedded derivative under SFAS 133 to continue to be adjusted to their contractual face amount, as its rationale for not permitting issuers to re-combine the separated

components of a convertible debt instrument once modified and no longer within the scope of the Proposed FSP.

In our view, the FASB's reference to EITF Issue 06-7 is not appropriate, as EITF Issue 06-7 addresses embedded derivatives bifurcated from a hybrid instrument under SFAS 133 and not the separation criteria set forth in the Proposed FSP, which criteria the FASB believes are consistent with the approached required by IAS 32, *Financial Instruments*. In the EITF's discussions of Issue 06-7, it was concluded that the model used under IAS 32 is not comparable to the consensus reached on the accounting for an embedded conversion option that does not meet the criteria for being classified within shareholders' equity. Also, the decision by the FASB to not permit an issuer to recombine a convertible debt instrument subsequently modified such that it is no longer in the scope of the Proposed FSP is inconsistent with the stated principle that the FASB believes that the Proposed FSP otherwise achieves, namely that instruments within its scope be accounted for based on their substance.

4. The Proposed FSP will significantly modify the accounting for convertible debt instruments that permit cash settlement upon conversion; however, there are a number of other related issues that exist in practice that have not been addressed including:

   – How consideration paid to modify a debt instrument should be treated in determining whether such a change results in a modification or extinguishment. Currently, the determination as to whether a modification or extinguishment of a debt instrument has occurred under EITFs 96-19 and 06-6 is made based on comparing the cash flows of the instrument using the book yield before the modification to the book yield after the modification. However, questions have been raised regarding what portion of convertible debt instruments within the scope of the Proposed FSP should be used to compute the book yield. We therefore recommend that the FASB clarify its guidance regarding modifications of instruments within the scope of the Proposed FSP to minimize any additional complexity and diversity that may affect the modification/extinguishment accounting model.

   – How the minimum number of shares should be determined for convertible debt instruments that permit the issuer to settle conversions in cash, shares or a combination thereof when determining whether an induced conversion has occurred.

   Not addressing these issues while changing the accounting for certain convertible debt instruments results in increased complexity in financial reporting and supports our view that a more comprehensive approach to addressing all significant issues in practice that pertain to convertible instruments should be considered.

5. Paragraph 12 of the Proposed FSP indicates that convertible debt instruments within its scope are not eligible for the fair value option pursuant to the scope exception in paragraph 8(f) of SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ("SFAS 159"). Paragraph 8(f) of SFAS 159 prohibits an entity from measuring financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders' equity. We disagree that instruments within the scope of the Proposed FSP should not be eligible for the fair value option under that scope exception because it is inconsistent with the FASB's view that such instruments are akin to debt issued with separately detachable and exercisable stock purchase warrants. We also recall that a host financial instrument resulting from the separation of an embedded nonfinancial derivative instrument within a nonfinancial hybrid instrument (e.g., a gross physically settled commodity forward contract) was not initially permitted to be measured at fair value under preliminary views of SFAS 159; however, the Board ultimately decided to allow such instruments to be measured at fair value. If the FASB decides not to permit the debt component of a convertible debt instrument within the scope of the Proposed FSP to be measured at fair value under SFAS 159, we recommend that the basis for the Board's decision be included in the final FSP.

6. SFAS 107, *Disclosure about Fair Value of Financial Instruments*, requires the fair value of financial instruments for which it is practicable to estimate that value be disclosed in either the body of the financial statements of the footnotes thereto. Because convertible debt instruments within the scope of the Proposed FSP, whose fair values are required to be disclosed pursuant to SFAS 107, will no longer be recognized and classified in the financial statements as unitary instruments, we recommend that the FASB clarify what portion of and how the instrument's fair value must be disclosed in the financial statements.

7. ISDA recommends the following modification to the Proposed FSP (inserted text is <u>underlined</u>).

    7. Some convertible debt instruments require <u>or permit</u> settlement of the if-converted value using the same form of consideration that holders of the underlying shares receive if conversion occurs in connection with a change-in-control transaction. Additionally, some convertible debt instruments require that an issuer's obligation to provide consideration for a fractional share upon conversion be settled in cash. The guidance in this FSP does not apply to convertible debt instruments that may provide for cash settlement (or partial cash settlement) only in the circumstances just described.

8. ISDA finds the illustration set forth in Appendix A useful and therefore supports its inclusion in the final guidance issued.