

# Capital Stock

## 12.2 OVERVIEW

Transactions involving capital stock are not considered as part of the results of operations. All significant transactions should be disclosed. (*See* Section 13 , ADDITIONAL PAID-IN CAPITAL; Section 14 , RETAINED EARNINGS; Section 15 , DIVIDENDS; and Section 16 , TREASURY STOCK, for additional details of transactions affecting stockholders' equity.)

## 12.3 MEASUREMENT PRINCIPLES

Although there are a number of measurement issues pertaining to capital stock transactions, many of them are not covered by the authoritative literature. Accordingly, the discussion in this section is based on promulgated GAAP as well as practices that have developed over the years.

### 12.3.1 Discount on Stock

Occasionally, common stock is issued below its par or stated value. The holder of shares issued below par may be called on to pay in the amount of the discount if, in liquidation, creditors sustain a loss. When stock is issued below par, it either creates an account called "Discount on Stock," which carries a debit balance, or it requires a charge to additional paid-in capital to the extent available from the same class of stock.

### 12.3.2 No-Par Stock

When no-par value stock is issued, there cannot be any premium or discount associated with it. Instead, the common stock account is credited for the entire amount of the sale.

Some states permit the issuance of no-par stock and then either require or allow the stock to have a stated value. A stated value is usually the minimum price at which the stock may be issued. Accounting for the issuance of stated value stock is similar to the accounting for par value stock and, if sold at a premium, requires a credit to additional paid-in capital.

### 12.3.3 Stock Sold on Subscription

In most states, individuals who have signed a subscription contract normally have the same rights as other stockholders.

#### Example 1. Stock Sold on Subscription

##### FACTS

Assume Client Company, Inc., offers its common stock on a subscription basis. The par value of the stock is \$2 per share, and purchasers agree to buy 10,000 shares at \$17 per share. At the time the subscription contracts are signed, 40% of the proceeds are paid, and the remaining 60% is payable in six months.

## SOLUTION

The journal entries would be:

At date of contract		
Cash (10,000 shares × \$17 × 40%)	68,000	
Subscriptions receivable (10,000 shares × \$17 × 60%)	102,000	
Common stock subscribed		20,000
Additional paid-in capital		150,000

To record common stock issued on subscription.

The receivable should appear as a current asset on the balance sheet. It may be shown as a deduction from stockholders' equity if there is no intention to collect the balance currently or when collection is dependent on a future event. Note that the SEC requires that subscriptions receivable be reported as a deduction from equity.

When the receivable is collected, the journal entry would be:

At the collection date		
Cash	102,000	
Common stock subscribed	20,000	
Common stock (issued)		20,000
Subscriptions receivable		102,000

To record the issuance of common stock on collection of subscriptions receivable.

Most subscription agreements provide that, upon default, any prior payments made by the subscriber toward the stock are not refundable. In such a situation, funds already received by the issuing company should be credited to additional paid-in capital.

### 12.3.4 Stock Sold Other Than for Cash

Stock may be sold in exchange for assets or services. In such a case, the item received should be recorded either at its fair value or the fair value of the stock issued, *whichever is more clearly determinable*. This principle also holds true for the issuance of treasury stock.

#### Example 2. Stock Sold Other Than for Cash

##### FACTS

Assume that Client Company, Inc., issues 5,000 shares of its \$2 par value common stock in exchange for consulting services. Client Company is closely held, and the fair market value of its stock is not known. If acquired for cash, the company would have to pay \$15,000 for the services.

##### SOLUTION

The journal entry would be:

Consulting services (expense)	15,000	
Common stock (5,000 shares × \$2)		10,000
Additional paid-in capital		5,000

To record issuance of 5,000 common shares in exchange for consulting services.

### 12.3.5 Stock Issuance Costs

Following is a list of the major common costs of issuing stock:

- Attorney's fees
- Accountants' fees
- Underwriters' fees and commissions
- Printing expenses
- SEC and/or state securities commission filing fees
- Advertising the issuance
- Administrative expenses of preparation of documents

Issue costs should be deducted from additional paid-in capital arising from the sale.

### 12.3.6 Convertible Preferred Stock

When issued, convertible preferred stock is recorded in the same manner as any other issue of stock. When converted, all that has really occurred is that one type of equity claim has been exchanged for another, and therefore the total amount of capital remains the same.

#### Example 3. Convertible Preferred Stock

##### FACTS

Assume that Client Company, Inc. has previously issued 10,000 shares of 8% convertible preferred stock with a par value of \$50 per share. The issue price was \$80 per share. Each preferred share is convertible into five shares of \$3 par value common stock.

##### SOLUTION

If all the shares were converted, the journal entry would be:

Convertible preferred stock	500,000	
Additional paid-in capital (created by the original sale)	300,000	
Common stock (10,000 shares × 5 × \$3)		150,000
Additional paid-in capital — common		650,000

The credit to additional paid-in capital on common stock of \$650,000 is computed as follows:

Original price paid by purchasers of preferred stock (10,000 shares × \$80)	\$800,000
Less: Par value of common stock on conversion (10,000 shares × 5 × \$3)	<u>(150,000)</u>
Proceeds received in excess of par value of common stock	<u>\$650,000</u>

Where the par value of the common shares issued exceeds the book value of the converted preferred stock, the difference is a charge to retained earnings. If, in Example 3, the par value of each common share were \$20, the journal entry would be:

Convertible preferred stock	500,000	
Additional paid-in capital — preferred	300,000	
Retained earnings	200,000	
Common stock (50,000 shares × \$20)		1,000,000

In this case, the preferred shareholders are viewed to have received a dividend of \$200,000 at the conversion date.

Where preferred shareholders are required, under the terms of the agreement, to pay cash *and* exchange the convertible preferred stock for common shares, the amount of the cash proceeds would increase the amount of additional paid-in capital on common stock arising out of the conversion.

### 12.3.7 Stock Rights

Rights issued by a company usually provide existing stockholders with the opportunity to acquire shares at below their market value. No accounting recognition is required when such rights are issued.

#### Example 4. Stock Rights

##### FACTS

Assume 20,000 shares of stock were issued at \$2 par, with additional paid-in capital being \$3 per share.

##### SOLUTION

When exercised, the following journal entry would be made (amounts assumed):

Cash (proceeds from the rights at \$5 per share)	100,000	
Common stock (20,000 shares × \$2 par)		40,000
Additional paid-in capital (20,000 shares × \$3)		60,000

To record the exercise of stock rights and the issuance of 20,000 shares of common stock.

See Section 2, MARKETABLE SECURITIES for a discussion of the accounting of stock rights by recipients.

### 12.3.8 Stock Warrants Sold Separately

When a company sells stock warrants separately (not attached to any other security), the amount of cash proceeds from the sale is credited to an account described as "Common stock warrants," which is usually combined with additional paid-in capital on the balance sheet.

### Example 5. Stock Warrants Sold Separately

#### FACTS

Assume Client Company, Inc. sells warrants for \$150,000. The holder is entitled to purchase 20,000 shares of \$3 par value common stock for \$9 per share.

#### SOLUTION

The journal entry at the date of sale would be:

Cash	150,000	
Common stock warrants		150,000

To record the sale of stock warrants.

The journal entry at the date of exercise would be:

Cash (20,000 shares × \$9)	180,000	
Common stock warrants	150,000	
Common stock (20,000 shares × \$3)		60,000
Additional paid-in capital		270,000

To record the exercise of warrants and the issuance of 20,000 shares of common stock.

The credit to additional paid-in capital of \$270,000 is calculated as follows:

Amount of proceeds:	
Sale of warrants	\$150,000
Sale of common stock	<u>180,000</u>
	330,000
Less: Par value of common stock issued (20,000 shares × \$3)	<u>(60,000)</u>
Proceeds received in excess of par value of common stock	<u>\$270,000</u>

## 12.3.9 Stock Warrants Issued With Another Security

Warrants may be issued as an attachment to preferred stock or bonds. In addition, a warrant issued in such a manner may be either detachable from the other security or nondetachable.

When stock warrants are *not* detachable from preferred stock, the preferred stock is equivalent to a convertible issue. The holder has one security, and the market value of the preferred stock and the stock warrant are inseparable. In such a case, all proceeds

received on the sale are deemed as allocated to the preferred stock and the accounting is identical to any other issue of stock. When warrants and cash are returned by holders in exchange for common stock, the journal entries are similar to those made in connection with convertible preferred stock.

When warrants are detachable, the accounting treatment is quite different. The action taken by a holder of preferred stock with a detachable warrant could be different with respect to each security. Each security (the warrant and the preferred stock) will have a separate market value. The price of the combined security should be allocated to the preferred stock and the warrants based on their relative market values at the time they are issued. Example 6 illustrates the appropriate accounting treatment.

### Example 6. Stock Warrants Issued With Another Security

#### FACTS

Assume that Client Company, Inc. issues 20,000 shares of \$5 par value preferred stock, with each share having a detachable warrant. By returning one warrant and \$40 in cash, the holder can purchase one share of \$2 par value common stock. The selling price of the preferred stock with the warrant is \$25. The market value of the security is determined to be \$20 for the preferred stock portion and \$8 for the warrant.

#### SOLUTION

The required computation at the date of issuance is:

Value of stock without warrant  
 Value of the combined security × Issue price = Value of stock  
\$20  
 $\$28 \times \$25 = \$17.85$  (value of each share of preferred stock)  
\$8  
 $\$28 \times \$25 = \$7.14$  (value of each warrant)  
\$17.85  
 $\$17.85 + \$7.14 \times 71.4\%$  (relative market value of each share of preferred stock)  
\$17.85 + \$7.14  
 $\$7.14 \times 28.6\%$  (relative market value of each warrant)

The journal entry at the time of issuance would be:

Cash (20,000 shares × \$25)	500,000	
Preferred stock (20,000 shares × \$5)		100,000
Additional paid-in capital — preferred (\$500,000 – \$100,000 × 71.4%)		285,600
Additional paid-in capital — warrant (\$500,000 – \$100,000 × 28.6%)		114,400

The total amount of additional paid-in capital of \$400,000 is allocated based on the relative market values of the preferred stock and the warrant.

When the warrants and cash are returned, the journal entry would be:

Cash (20,000 warrants × \$40)	800,000	
Additional paid-in capital — warrants	114,400	
Common stock (20,000 shares × \$2)		40,000

Additional paid-in capital — common stock 874,400

The credit to additional paid-in capital for common stock is calculated as follows:

Amount of proceeds from holders of the warrants:	
On issuance	\$114,400
On return of the warrants	<u>800,000</u>
	914,400
Less: Par value of common stock issued (20,000 shares × \$2)	<u>(40,000)</u>
	<u>\$874,400</u>

A question arises regarding how debt stock that is issued with detachable stock purchase warrants should be accounted for when the warrant also gives the holder the right to require the issuer to repurchase some or all of the warrant several months after the maturity date of the debt.

The Emerging Issues Task Force has reached a consensus that the proceeds from issuance should be allocated between the debt and warrant portions. Any resulting discount should be amortized on the interest method. The original carrying amount of the warrant should be increased to the "put" price, with the corresponding charge made to interest expense (not to equity, since the warrant should be characterized as a debt instrument).

### **Contingent stock warrants.**

**Contingent stock warrants.** Contingent warrants to purchase its stock issued by a supplier to a customer that become exercisable upon the condition that the customer acquire a specified amount of the supplier's product over a period of time should be accounted for in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (see Section 52, STOCK OPTION AND PURCHASE PLANS). SFAS No. 123 requires that the cost of such contingent warrants be based on their fair value.

## **12.3.10 Convertible Debt**

When convertible debt is issued, no accounting recognition is given to the conversion feature. Only upon conversion is there an accounting for the conversion portion of the debt. At conversion, either the market value or book value method may be used. Under the market value method, a gain or loss may occur. Under the book value method, the stock issued upon conversion is valued at the carrying value of the converted bonds. The book value method, which is used most often in practice, has the effect of altering the nature of the convertible debt holder from a contingent stockholder to an actual one. An example of the book value method follows.

### **Example 7. Conversion of Debt**

#### **FACTS**

Assume that Client Company, Inc. has previously issued \$1,000,000 face value convertible bonds. At the conversion date, the unamortized discount is \$20,000. The bonds are convertible into 50,000 shares of \$5 par value Client Company common stock.

#### **SOLUTION**

The journal entry to be made upon conversion is:

Bonds payable	1,000,000	
Discount		20,000
Common stock (50,000 shares × \$5)		250,000
Additional paid-in capital		730,000

Note that the EITF has concluded that, upon conversion between interest dates, accrued interest (or imputed interest, in the case of zero-coupon debt) should be accounted for in the same manner as the principal amount of the converted debt and any unamortized premium or discount (i.e., the net carrying amount of the debt should be credited to additional paid-in capital).

**Debt convertible into a subsidiary's stock.** For debt issued either by a consolidated subsidiary that is convertible into its own stock or debt issued by a parent that is convertible into a consolidated subsidiary's stock, the EITF has concluded that:

- In the consolidated statements, no portion of the proceeds from the issuance of the convertible debt should be accounted for as attributable to the conversion feature.
- The difference between the face amount of the debt and the proceeds received at issuance should be considered a discount or premium.

**Convertible securities with beneficial conversion features or contingently adjustable conversion ratios.** The EITF has addressed the issuance of convertible debt and convertible preferred stock with a nondetachable conversion feature that are in-the-money at the commitment date (i.e., the date on which investors are committed to purchase the securities). Such a feature is termed a "beneficial conversion feature" because the securities may be converted into common stock at the lower of a fixed rate at the commitment date or a discount to the market price of the underlying common stock at the conversion date.

The Task Force reached the following consensuses:

- Embedded beneficial conversion features should be recognized and measured by allocating a portion of the proceeds to additional paid-in capital equal to intrinsic value of the features; such amount should be calculated at the commitment date as the difference between the conversion price and the fair value of the common stock or other instruments into which the security is convertible.
- If the intrinsic value of the beneficial conversion feature is greater than the proceeds allocated to the convertible security itself, the amount of discount assigned to the conversion feature is limited to the amount of the proceeds allocated to the convertible security. For convertible preferred stock, the recorded discount is analogous to a dividend and should be recognized as a return to preferred stockholders over the period from the date of issuance to the earliest conversion date using the effective yield method. For convertible debt securities, the recorded discount is considered interest expense and should be so recognized using the effective yield method, over the period from the issuance date to the earliest conversion date.
- For securities that become convertible only upon the occurrence of a future event outside the holder's control or for securities that are convertible at issuance but contain conversion terms that change upon the occurrence of a future event, the

beneficial conversion feature should be measured at the commitment date but not recognized until the contingency is resolved.

In applying the foregoing consensus, the EITF has provided the following guidance:

- In determining whether an instrument contains a beneficial conversion option, intrinsic value should be calculated using the effective conversion price, which is based on the proceeds received for (or allocated to) the convertible instrument.
- Regarding a contingent conversion option, the most favorable conversion price in effect at the commitment date should be used to measure intrinsic value.
- For a contingent conversion feature that reduces (resets) the conversion price if the underlying stock's value declines after the commitment date to or below a specified price, recognition is required when the reset occurs.
- A commitment is a legally enforceable agreement binding on both parties that (1) spells out all significant terms (i.e., the quantity to be exchanged, the price, and the timing of the transaction), and (2) includes a disincentive for nonperformance that is sufficiently large to make performance probable. The date on which both of these conditions are met is deemed the commitment date, which is the date used to determine fair values for purposes of allocating proceeds.
- For convertible instruments with stated redemption dates (e.g., debt, mandatorily redeemable preferred stock), any discount resulting from recording a beneficial conversion option should be amortized from the date of issuance to the redemption date (regardless of when the earliest conversion date occurs). Any remaining discount at the date of conversion should be recognized as interest expense (on convertible debt) or as a dividend (on preferred stock).
- Costs of issuing the convertible securities should not be offset against the proceeds received in calculating intrinsic value of the conversion option.
- When the terms of a contingent conversion option do not allow the number of shares to be issued upon occurrence of the contingent event to be determined, intrinsic value should be measured and recognized when the event triggering conversion takes place; in such a case, only the *incremental* intrinsic value should be recorded (i.e., the excess over the amount that would have otherwise been recognized prior to occurrence of the contingent event).
- If a beneficial conversion option terminates at a specified time and the instrument then becomes mandatorily redeemable at a premium, the instrument is then deemed a liability to be accounted for under SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (see Section 39 , FINANCIAL INSTRUMENTS, DERIVATIVES, AND HEDGING ACTIVITIES).
- For convertible securities issued as non-discretionary paid-in-kind (PIK) interest or dividends (i.e., neither party can elect another form of payment), the commitment date for the original instrument is also deemed the commitment date for the convertible securities issued as PIK; thus, the intrinsic value of the embedded conversion option in the PIK instruments is measured using the fair value of the underlying stock at the commitment date of the original issuance.
- When a convertible security is issued in repayment of a non-convertible instrument (but not as part of a troubled debt restructuring), the fair value of the new security is equal to the amount owed at the maturity date of the old debt. Thus, intrinsic value would be measured based on the redemption value of the retired debt.

The following examples illustrate the basic provisions of the foregoing consensus.

#### **Example 8. Fixed Dollar Conversion Terms**

## Facts

Assume that Client Company, Inc., issues convertible debt of \$500,000; the debt is convertible at \$20 per share, and the market price is \$25 per share at the commitment (issuance) date.

## Solution

The beneficial conversion feature represents the intrinsic value at the commitment date, which is computed as \$5 ( $\$25 - \$20$ ) times 25,000 shares ( $\$500,000 \div \$20$ ), or \$125,000. If the debt is convertible immediately, the value of the beneficial conversion feature is charged to interest expense at the date of issuance with a corresponding credit to additional paid-in capital. The journal entry to record issuance of the debt would thus be:

Cash	500,000	
Interest expense	125,000	
Long-term debt		500,000
Additional paid-in capital		125,000

Note that if the conversion feature is not operable at issuance, the \$125,000 would be charged instead to debt discount and amortized on the interest method over the period from the issuance date to the first available conversion date.

## Example 9. Fixed Percentage Conversion Terms

### Facts

Assume the same facts as in Example 8 , except that the debt is convertible at 80% of the market price on the commitment date. Also assume that the debt is convertible at issuance.

### Solution

The intrinsic value of the beneficial conversion feature is \$125,000, computed as \$5 times 25,000 shares. Because the debt is immediately convertible, the \$125,000 is charged to interest expense just as it was in Example 8 .

## Example 10. Variable Percentage Conversion Terms

### Facts

Assume the same facts as in Example 8 , except that the debt is convertible at the lower of 80% of the market price when converted or \$20. Again, assume that the debt is convertible at issuance.

### Solution

As in the previous example, the intrinsic value is \$125,000, which is charged to interest expense when the debt is issued. Even if the conversion feature were not operational

immediately (and thus the actual share price at conversion was not known at inception), the amount of intrinsic value (\$125,000) would not be adjusted in the future to recognize a change in the share price. Note, however, that at issuance, the \$125,000 would be charged to debt discount and amortized on the interest method to the first conversion date.

### Example 11. Fixed Percentage Conversion Feature Dependent on a Future Occurrence

#### Facts

Assume that Client Company issues \$500,000 of convertible debt, which is convertible only upon the occurrence of a specified future event. The market price on the commitment date is \$25 per share, and the debt is convertible at 80% of the market price on the commitment date.

#### Solution

Intrinsic value of the beneficial conversion feature is \$125,000. Note, however, that the beneficial conversion feature is recognized only upon occurrence of the specified event. At issuance of the debt, the journal entry is:

Cash	500,000	
Long-term debt		500,000

Upon occurrence of the event, the entry would be:

Interest expense	125,000	
Additional paid-in capital		125,000

### Example 12. Conversion Terms Dependent on a Future Occurrence

#### Facts

Assume that Client Company, Inc., issues \$500,000 of convertible debt that is convertible at issuance at \$20 per share. The market price on the commitment date is \$25 per share. If the market price increases at least 20% one year after a specified future event, the conversion feature is adjusted to 60% of the market price.

#### Solution

Under the terms of the arrangement, the beneficial conversion feature comprises the intrinsic value at the date of issuance of \$125,000 ( $\$5 \times 25,000$  shares) and the intrinsic value of a contingent conversion feature, which is computed as follows:

Market price at commitment date	\$25
Targeted increase ( $\$25 \times .20$ )	<u>5</u>
	<u>30</u>
Conversion price ( $\$30 \times .60$ )	<u>18</u>
Number of shares upon conversion ( $\$500,000 \div \$18$ )	27,778
Total intrinsic value per share ( $\$30 - \$18$ )	<u><u><math>\times \\$12</math></u></u>

Total intrinsic value	333,336
Intrinsic value at commitment date	<u>(125,000)</u>
Intrinsic value of contingent beneficial future	<u>\$208,336</u>

The journal entry at issuance would be:

Cash	500,000	
Interest expense	125,000	
Long-term debt		500,000
Additional paid-in capital		125,000

Assuming the specified future event takes place and the targeted share price is achieved, the journal entry to record the intrinsic value of the beneficial conversion feature would be:

Interest expense	208,336	
Additional paid-in capital		208,336

### Example 13. Extinguishment of Debt with a Beneficial Conversion Feature

#### Facts

Assume that before conversion, Client Company, Inc., extinguishes convertible debt that contains a beneficial conversion feature. The debt was not convertible at issuance. On the date of extinguishment, the unamortized conversion feature had been fully amortized. On that date, the intrinsic value of the conversion feature was \$50,000 and the face value of the debt was \$650,000.

#### Solution

The journal entry to record the extinguishment is as follows:

Long-term debt	650,000	
Additional paid-in capital	50,000	
Loss on extinguishment of debt	20,000	
Cash		720,000

The loss on extinguishment of \$20,000 represents the difference between the \$720,000 cash paid to the debt holders and the sum of the face value of the debt plus the intrinsic value on the extinguishment date of the beneficial conversion feature (\$650,000 + \$50,000).

The EITF reached the following consensus regarding equity securities issued to settle a debt instrument that becomes convertible upon the issuer's exercise of a call option:

- If the debt instrument contained a "substantive conversion" feature under its original terms, issuance of the equity securities should be accounted for as a conversion (i.e., no gain or loss should be recognized).
- If the debt instrument did not contain a substantive conversion feature under its original terms, issuance of the equity securities should be accounted for as

extinguishment of the debt (i.e., the fair value of the equity securities should be considered a component of the reacquisition price of the debt).

To qualify as a substantive, the conversion feature must be at least reasonably possible of being exercisable (without consideration of the issuer's exercise of its call option). The Task Force provided the following list of factors, which is not intended to be all inclusive, to be taken into account when assessing whether a conversion feature is substantive:

- The relationship of the conversion feature to the fair value of the entire debt instrument.
- The relationship of the debt instrument's effective interest rate to the estimated effective rate of a non-convertible debt instrument having an equivalent expected term and credit risk.
- The relationship of the debt instrument's fair value to an identical instrument for which conversion is not contingent.
- The nature of the conditions under which the instrument may become convertible (e.g., the likelihood that the contingent event will occur prior to the instrument's maturity date).

### **12.3.11 Induced Conversions of Convertible Debt**

SFAS No. 84 requires the company to recognize upon conversion an expense equal to the fair value of the incremental consideration (the inducement or "sweetener") paid. This requirement applies to convertible debt only if both of the following conditions are met:

- The conversion occurs pursuant to changed conversion privileges that are exercisable only for a limited time.
- The conversion includes the issuance of all the equity securities that are issuable pursuant to the original conversion privileges for each debt instrument converted.

Following is an example of the appropriate accounting treatment.

#### **Example 14. Improved Conversion Ratio**

##### **FACTS**

On January 1, 20X4, Client Company, Inc., issues a \$1,000-value 10% convertible bond maturing December 31, 20X3. The carrying amount of the bond in the financial statements of Client Company is \$1,000, and it is convertible into common shares of Client Company at a conversion price of \$25 per share. On January 1, 20X6, the convertible bond has a market value of \$1,700. To induce convertible bondholders to convert their bonds promptly, Client Company reduces the conversion price to \$20 for bondholders who convert prior to February 29, 20X6 (i.e., within 60 days).

##### **SOLUTION**

Assuming the market price of Client Company's common stock on the date of conversion is \$40 per share, the fair value of the incremental consideration paid by the Company on conversion is calculated as follows for each \$1,000 bond that is converted prior to February 29, 20X6:

Additional share to be issued:

Face value of bond divided by new conversion price ( $\$1,000 \div \$20$ )	50	shares
Face value of bond divided by old conversion price ( $\$1,000 \div \$25$ )	<u>(40)</u>	shares
Incremental shares	10	shares
Market price per share at conversion date	<u><math>\times \\$40</math></u>	
Fair value of incremental consideration	<u>\$400</u>	

At the \$25 per share conversion price, the value of conversion would be only \$1,600 (40 shares  $\times$  \$40), and when compared to the \$1,700 market value of the bond, conversion would not be an attractive alternative. However, at the "sweetened" conversion price of \$20 per share, the value of conversion would be \$2,000 (50 shares  $\times$  \$40) and would induce conversion when compared to the \$1,700 market value of the bond.

The journal entry upon conversion would be:

Convertible bond	1,000	
Debt conversion expense	400	
Common stock (and additional paid-in capital)		1,400

Note that the EITF has concluded that SFAS No. 84 applies as well to conversions resulting from offers of sweetened terms initiated by debt holders (rather than by the issuer, as is normally the case), even if the inducements to convert do not extend to all holders of the convertible debt.

### 12.3.12 Redeemable Preferred Stock

SEC Reg. S-X requires the exclusion of redeemable preferred stock from stockholders' equity; it also requires that the redemption amount be disclosed on the face of the balance sheet. (See Section 39, FINANCIAL INSTRUMENTS, DERIVATIVES, AND HEDGING ACTIVITIES, for further discussion of the measurement and balance sheet classification of mandatorily redeemable preferred stock). In SAB No. 64, the Staff addresses both the treatment of the carrying amount of such preferred stock and the treatment of periodic increases in the carrying amount for the computations of the earnings per share (EPS) and the ratios of earnings to combined fixed charges and preferred stock dividends.

The initial carrying amount of redeemable preferred stock should be at its fair value at the date of issuance. If the fair value is less than the mandatory redemption amount, periodic accretions using the interest method should be made so that the carrying value will equal the redemption amount on the mandatory redemption date. The initial carrying value should also be increased periodically by dividends that have not been currently declared or paid but will be due under the redemption agreement, or for which ultimate payment is not solely within the registrant's control (e.g., dividends payable out of future earnings). In all cases, the corresponding debit in an accretion to redeemable preferred stock should be to retained earnings (or to additional paid-in capital in the absence of retained earnings). This treatment also applies when the redeemable preferred stock may be voluntarily redeemed by the registrant before the mandatory redemption date and when such preferred stock may be converted into another class of securities by the holder.

If currently redeemable, the stock's carrying amount should be adjusted to its redemption value at each reporting date. If the stock will become redeemable in the future (but the redemption amount is variable) (1) the interest method or other

appropriate method may be used to accrete changes in redemption value to the earliest redemption date, with the effect of the change treated as a change in accounting estimate, or (2) changes in redemption value may be immediately recognized as an adjustment to the preferred stock's carrying amount.

The SEC Staff expects consistent application of the accounting method selected regarding redemption value when a security is expected to become redeemable (i.e., either: (1) through accretion in the redemption value over the period from the date it becomes probable that it will be redeemable to the earliest redemption date; or (2) through recognition of changes in the redemption value immediately as they occur with an adjustment of the carrying value of the security to equal the redemption value at the end of each reporting period). Moreover, disclosure of the redemption value of the security as if it were redeemable is required for companies electing to accrete changes in the redemption value.

Regardless of the method used, resulting increases or decreases in the carrying amount of redeemable common stock: (1) should be treated in the same manner as dividends on non-redeemable stock (i.e., with a corresponding charge against retained earnings); and (2) should not affect the amount of income attributable to common stockholders (i.e., the right to redeem such stock at other than fair value is, in substance, a preferential distribution that should be reflected in EPS using the two-class method).

In computing EPS and the ratios of earnings to combined fixed charges and preferred stock dividends, all types of accretions should be treated in the same manner as are dividends on nonredeemable preferred stock.

Upon redemption of preferred stock, the SEC Staff believes that the excess of fair value of the consideration transferred to the holders of the preferred stock over the carrying amount of the preferred stock in the balance sheet should be subtracted from net earnings to arrive at net earnings available to common shareholders. In addition, the carrying amount of the preferred stock should be reduced by the costs of original issuance, regardless of where in stockholders' equity such costs are classified. The Staff believes that such an excess represents a return to the preferred stockholder and, therefore, should be treated in a manner similar to the treatment of dividends paid to the holders of the preferred stock in the calculation of earnings per share. Likewise, an excess of the carrying amount of preferred stock over the fair value of the consideration transferred to the holders of the preferred stock would be added to net earnings to arrive at net earnings available to common shareholders. Note that, if the preferred stock is mandatorily redeemable, the excess (or shortfall) of the fair value transferred over (under) the carrying value of the stock would be accounted for, pursuant to SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, as a loss or gain on the extinguishments of debt and reflected in net earnings and thus in the numerator when calculating earnings per share (see Section 39 , FINANCIAL INSTRUMENTS, DERIVATIVES, AND HEDGING ACTIVITIES). Note that the SEC Staff expects that an evaluation will be made to determine whether the terms of instruments granted to employees that are not classified as liabilities under SFAS No. 123(R), *Share-Based Payment*, require presentation outside permanent equity. The Staff will not assume that cash settlement is required in respect of instruments granted to employees in share-based arrangements that do not, by their terms, require redemption for cash or other assets at a fixed or determinable price on a fixed or determinable date at the holder's option.

However, it is the Staff's view that for options or similar instruments granted in share-based payment arrangements that permit redemption of the option or underlying shares, the initial amount to be reported outside permanent equity should be based on the

instrument's redemption provisions (e.g., for a fully vested option allowing the holder to put the option back to the issuer at its intrinsic value upon a change in control of the issuer, the option's intrinsic value at the date of issuance should be presented outside of permanent equity).

If convertible preferred stock is converted to other securities issued by the registrant pursuant to an inducement offer, the Staff believes that the excess of the fair value of all securities and other consideration transferred in the transaction by the registrant to the holders of the convertible preferred stock over the fair value of securities issuable pursuant to the original conversion terms (reduced by the costs of original issuance) should be subtracted from net earnings to arrive at net income available to common shareholders in the calculation of earnings per share.

**Parent's acquisition of a subsidiary's preferred stock.** The EITF reached a consensus on the accounting for early extinguishment of a subsidiary's preferred stock. The EITF concluded that a parent's acquisition of a subsidiary's preferred stock should be treated as a capital transaction, with no resulting gain or loss. The consolidated entity's recognition of any gain or loss from the acquisition of such stock should not be made at a price that is different from the stock's carrying value. Note that this consensus does not apply to a subsidiary's mandatorily redeemable preferred stock, which is deemed a liability pursuant to SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (see Section 39 , FINANCIAL INSTRUMENTS, DERIVATIVES, AND HEDGING ACTIVITIES).

### **12.3.13 Increasing-Rate Preferred Stock**

Increasing-rate preferred stock (including redeemable) preferred stock) either:

- Pays *no* dividends during the initial years, but then pays dividends at the market rate in later years; or
- Pays dividends during the initial years at below-market rates, but then pays dividends at the market rate in later years.

The SEC Staff requires that increasing-rate preferred stock be recorded at its fair value at issuance followed by periodic increases in the carrying value during the initial years when dividends are not paid or are paid at below-market rates.

When increasing-rate preferred stock is issued, the issue price reflects a number of factors, including the issuer's creditworthiness, market conditions, and the dividend rates in both early and later years. Thus, the existence of low (or no) dividend payments in the initial years followed by a market rate dividend (the "perpetual dividend") in the later years should result in the preferred stock being issued at a discount.

The SEC Staff requires that the recorded value at issuance be periodically increased by a debit to retained earnings and a credit to the carrying value of the preferred stock. In effect, the discount at issuance should be amortized directly to retained earnings for the imputed dividend cost.

The discount at issuance is the present value of the difference between the dividends, if any, in the early years and the perpetual dividend for that same period. Present value should be computed using a market rate for dividend yield on comparable preferred stocks. Annual amortization should be the amount that, together with any stated dividend for the year (ignoring fluctuations in stated dividend amounts resulting from variable

rates), results in a constant rate of effective cost (i.e., the interest method, as described in APB No. 21). To illustrate the procedure, consider the following example;

### Example 15. Imputation of Dividends

#### FACTS

Assume the registrant issues increasing-rate preferred stock that will pay no dividends during 20X1, 20X2, and 20X3. In 20X4 and thereafter, dividends will be paid at \$8 per share. At issuance on January 1, 20X1, 8% is considered an appropriate market rate, and the preferred stock is issued for \$79.38 per share, with a resulting discount of \$20.62 per share.

#### SOLUTION

If 8% is an appropriate market rate and the perpetual dividend will be \$8 per share, the preferred stock could have been issued at \$100. The following schedule illustrates imputation of dividend cost.

Year	Carrying value	Imputed dividend cost
Issuance at 1/1/X1	\$79.38	\$6.35
12/31/X1	85.73	6.86
12/31/X2	92.59	7.41
12/31/X3	100.00	--

The charge to retained earnings in years 20X1, 20X2, and 20X3 will be the imputed dividend cost in each of those years. It is calculated as 8% of the prior carrying value. Also, each year the carrying value of the preferred stock increases by the year's imputed dividend cost, so at the beginning of 20X4 it is \$100.

Note also that in computing EPS, the imputed dividend cost should be deducted in arriving at net income applicable to common stockholders.

When below-market rates are involved, the amount of dividends deducted to compute net income applicable to common stockholders includes both the cash dividend and the discount amortization.

The SEC Staff also advises that if stated dividends on increasing-rate preferred stock are variable, computation of initial discount and subsequent amortization should be based on the value of the related index at the date of issuance and should not be affected by subsequent changes in the index.

The SEC Staff has taken a position on convertible preferred stock and convertible securities with a nondetachable conversion feature that is "in the money" at the date of issuance (also referred to as a "beneficial conversion feature"). Under the terms of such securities, they may be convertible into common stock at the lower of a conversion rate that is fixed at the date of issue or at a fixed discount to the common stock's market price at the conversion date.

The SEC Staff believes that a beneficial conversion feature should be recognized and measured by allocating a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. That amount should be calculated at the date of issue as the difference between the conversion price and the fair value of the common

stock into which the security is convertible, multiplied by the number of shares into which the security is convertible. If the security provides more than one method of determining the conversion rate, then the computation should be made using the conversion terms that are most beneficial to the investor. If the registrant's common stock is traded in a public market, the Staff believes that the quoted market price is the best measure of the common stock's fair value and that the quoted market price should not be adjusted to reflect transferability restrictions, large block factors, avoided underwriters' fees, or time value discounts, because of the difficulty in measuring those factors objectively.

For convertible preferred securities, the SEC Staff believes that any discount resulting from an allocation of proceeds to the beneficial conversion feature is analogous to a dividend and should be recognized as a return to the preferred shareholders over the minimum period in which the preferred shareholders can realize that return. The Staff believes that issuers of those securities should apply the guidance in SAB No. 68 and amortize the resulting discount using the effective interest method from the date of issuance through the date the security is first convertible.

For convertible debt securities, the SEC Staff believes that any discount resulting from an allocation of proceeds to the beneficial conversion feature increases the effective interest rate of the security and should be reflected as a charge to interest expense. Because the security has been issued with beneficial conversion terms, the Staff has presumed that the stated maturity date of the instrument is not substantive and that, therefore, the amortization period should be from the date the security is issued to the date it first becomes convertible. If the issuer reasonably determines that a period other than the period to the first conversion date is substantive, the discount should be amortized over that period. In that circumstance, if the security is converted prior to full amortization of the discount, the Staff believes that the unamortized portion of the discount should be charged to interest expense in the period of conversion.

### **12.3.14 Convertible Bonds With a Premium Put**

A premium put allows investors to redeem bonds for cash at a multiple of its fair value (e.g., 120% of par) at a point prior to maturity. The EITF has concluded that a liability should be accrued over the period from the date of issuance of the debt to the first date on which the put can be exercised. The liability thus should equal the redemption price and should continue to be accrued regardless of changes in either the market price of the bonds or the underlying stock into which it is convertible. If the put expires unexercised, accounting for the liability depends upon the relative market values of the put and the underlying common stock. If the market price of the stock exceeds that of the put itself, the liability should be removed with a corresponding credit to additional paid-in capital. If the market price of the put is higher, the liability should be amortized as a yield adjustment over the remaining term of the bonds.

### **12.3.15 Convertible Bonds With Issuer Option to Settle for Cash**

The Emerging Issues Task Force has addressed the situation in which, upon conversion, the issuer of a debt instrument that is convertible into a fixed number of common shares is either required or has the option to settle all or part of the obligation in cash. If the holder does not exercise the conversion option, the issuer must settle the debt obligation in cash. The three possible variations of this scenario are:

(A) Upon conversion, the issuer must satisfy the obligation entirely in cash based on the fixed number of shares multiplied by the stock price on the date of conversion (the conversion value).

(B) Upon conversion, the issuer may satisfy the entire obligation in either cash equivalent to the conversion value or stock.

(C) Upon conversion, the issuer must satisfy the accreted value of the obligation in cash and may satisfy the conversion spread (the excess conversion value over the accreted value) in either cash or stock.

The Task Force has reached the following consensuses:

- The issuer should provide for combined accounting for the conversion feature and debt obligation, regardless of the manner in which the obligation is settled.
- Variations *A* and *C* should be accounted for similarly to indexed debt obligations. The issuer should adjust the carrying amount of the instrument in each reporting period to reflect the current stock price, but not below the accreted value of the instrument. Adjustments to the carrying amount should be included currently in income and not spread over future periods. For variation *C*, upon settlement, if the conversion spread is settled in stock, only the amount of cash paid (i.e., for settlement of the accreted value) should be considered as part of the gain or loss on extinguishment of the recognized liability (i.e., the accreted value). Variation *B* should be accounted for as conventional convertible debt. If the holder exercises the conversion option and the issuer satisfies the obligation in cash, the debt should be considered extinguished at that time.
- As for the computation of EPS, the if-converted method should not be applied for the accreted value required to be settled in cash (variation *C*). The if-converted method should be used for the conversion spread in calculating diluted EPS.

The EITF also concluded (upon reconsideration of this issue) that, regarding variation *C*, such an instrument should be considered as equity if it qualifies as such pursuant to EITF No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, or Potentially Settled in, a Company's Own Stock" (see Section 39, FINANCIAL INSTRUMENTS, DERIVATIVES, AND HEDGING ACTIVITIES). If the instrument does not meet the criteria in Issue 00-19 for equity classification, it should be marked to market and accounted for in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (see also, Section 39).

## 12.4 DISCLOSURES

GAAP requires that disclosures pertaining to capital stock explain the pertinent rights and privileges of capital stock outstanding. The following information should be disclosed where applicable for each issue of capital stock outstanding:

Separate identification of each issue.

The aggregate amount.

The par, stated, or assigned value per share.

The number of shares authorized.

The number of shares issued.

The number of shares outstanding. Shares of stock of the parent company owned by a subsidiary should not be shown as outstanding in a consolidated balance sheet.

Dividend rates.

Liquidation preferences.

Participation rights.

Conversion or exercise prices or rates and dates.

Sinking fund requirements.

Unusual voting rights or other unusual privileges.

Significant terms of contracts to issue additional shares

A description and the number of shares reserved and the purpose for such reservation.

A description and the number of shares issued in a pooling of interests.

A description and the number of shares issued or issuable in a purchase and the amount assigned to these shares.

Details pertaining to stock option and stock purchase plans.

Exercise and expiration dates and prices of warrants or rights.

In the balance sheet itself, the aggregate liquidation preference significantly in excess of par or stated value of preferred (or other senior) stock.

Separately, by issue or combined, redemption requirements for stock that is redeemable at fixed or determinable dates during each of the five years subsequent to the latest balance sheet presented.

The aggregate or per-share amounts at which preferred stock may be called or is subject to redemption through sinking fund or other mandatory provisions.

For convertible debt or preferred stock that contains a beneficial conversion feature (i.e., a security that is in-the-money at the date investors are committed to purchase it), the following should be disclosed:

- The terms of the transaction;
- The excess of aggregate fair value of the underlying common stock that holders would receive at conversion over the proceeds received;
- The period over which the discount (i.e., the excess of the intrinsic value of the conversion feature over the proceeds allocated to the convertible security) is being amortized.
- The aggregate and per-share amounts of dividend arrearages on cumulative preferred stock.
- Information pertaining to transactions affecting capital stock that occur after the date of the financial statements but before they are issued.
- Separate identification on the balance sheet of amounts due from stock subscriptions.
- Details of changes in capital stock accounts and the changes in the number of shares outstanding for at least the most recent year and any subsequent interim period presented. These disclosures may be made in the financial statements or in a note. When significant or numerous transactions have occurred, a separate statement of stockholders' equity is often presented, and the details of changes in all equity accounts are included. Note that GAAP requires that details of changes be presented only for the most recent year and any subsequent interim period presented.

Regarding contingently convertible securities:

- Terms to be disclosed should include: (1) the conversion price and the number of shares into which the security is convertible; (2) a description and significant terms of the events or changes in circumstances that could adjust or alter the contingency, the conversion price or number of shares; and (3) the manner of settlement upon conversion, including alternative settlement methods (e.g., shares, cash, or a combination thereof).
- Disclosure is also required of: (1) the events or changes in circumstances that would cause the contingency to be met; and (2) the periods in which such contingency might be met (and thus the periods in which the securities may be converted).
- Disclosure should be made of whether contingently convertible shares that would be issued upon conversion are included in the calculation of diluted EPS and the reasons why they have or have not been so included.

- If derivative transactions have been entered into in connection with the issuance of contingently convertible securities, disclosure should be made of: (1) the terms of such transactions, including settlement thereof; (2) how such transactions relate to the contingently convertible securities; and (3) the number of shares underlying the derivatives. Note that an example of such a derivative transaction is the purchase of a call option whose terms would be expected to offset changes in value of the written call option embedded in the convertible security.

### 12.4.1 Examples

## **SSA Global Technologies, Inc. (2005 Form 10-K)**

Example .

#### Other Long-term Debt

##### *Mandatorily redeemable stock appreciation rights*

On February 1, 2004, the Company renegotiated the EXE Dallas lease in order to terminate its obligations to lease unoccupied space in exchange for \$6.0 million in cash and stock appreciation rights. The stock appreciation rights entitled the holder to 127,281 shares of the Company's common stock, subject to antidilution adjustment, upon consummation of an initial public offering. The Company had presented this obligation as long-term debt at fair value as of July 31, 2004 since it was mandatorily redeemable until the IPO, when it was converted into 127,281 shares of common stock. As the stock appreciation rights were mandatorily redeemable at \$2.5 million and had no stated interest rate, the Company discounted the \$2.5 million at 5% per annum (\$2.4 million at May 31, 2005 and \$2.3 million at July 31, 2004) and recorded interest expense monthly. The balance was reclassified to stockholders' equity upon consummation of the IPO.

## **Corvu Corporation (2004 Form 10-K)**

Example .

## DEBT AND EQUITY TRANSACTION

In February 2005, the Company and ComVest Investment Partners LLC (ComVest) completed a debt and equity financing which included: (1) an equity investment of \$3,300,000 in exchange for 22,000,000 shares of the Company's common stock at a price of \$0.15 per share; (2) a preferred stock and warrant investment of \$1,700,000 in exchange for 17,000 shares of a Series C Convertible Preferred Stock ("Series C Preferred Stock"), plus five-year warrants to purchase up to 3,400,000 shares of the Company's common stock at an exercise price of \$0.50 per share, and (3) a collateralized loan in the principal amount of \$1,500,000.

Each share of Series C Convertible Preferred Stock has a par value of \$100 and is convertible into 200 shares of the Company's common stock, subject to customary anti-dilution provisions. In addition, holders of the Series C Convertible Preferred Stock are entitled to voting rights together with the common stock, on an as-if converted basis. The Series C Convertible Preferred Stock accrues cumulative quarterly dividends of \$1.50 per share during the first year after issuance, \$2.25 per share during the second year after issuance, and \$3.00 per share during the third year after issuance. The Company has the right to redeem Series C Convertible Preferred Stock at any time upon 10 business days prior written notice upon payment of \$100 per share plus accumulated but unpaid dividends; holders of Series C Convertible Preferred Stock may elect to convert the stock at any time. The fair value of the warrants at the date of grant was estimated to be approximately \$748,000 using the Black-Scholes pricing model. The following assumptions were used to calculate the fair value of the warrants: dividend yield of 0%; expected volatility of 122%; risk-free interest rate of 3.375%; and an expected life of five years. As defined in Emerging Issues Task Force (EITF) 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments", it was determined that there was no resulting beneficial conversion of the Series C Convertible Preferred Stock. Upon liquidation of the Company, each share of Series C Convertible Preferred Stock entitles its holder to receive an amount of \$150, prior and in preference to holders of common stock and any other preferred stock. In accordance with Staff Accounting Bulletin Topic 5, "Increasing Rate Preferred Stock", the Company has increased the carrying value of the Series C Convertible Preferred stock by \$90,000, represented as the net present value of the difference between the actual stated value of dividends payable in the first two years after issuance and the effective dividends based on a 12% market rate during those periods. For the year ended June 30, 2005, the Company has amortized \$22,500 of the effective dividend discussed above. In addition, the Company has recorded dividends of \$39,100 for the year ended June 30, 2005, of which \$25,500 are accrued for as of June 30, 2005.

The loan is collateralized by substantially all of the assets of the Company and ranks senior to any existing or future indebtedness of the Company. The interest rate for the loan is 6% during the first year of the loan, 9% during the second year and 12% for the third year. The loan becomes immediately due and payable upon the earlier of (i) 36 months from the date of issuance (February 2008), (ii) a merger or combination of the Company or a sale of all or substantially all of the assets of the Company, or (iii) the acquisition of more than 50% of the voting power or interest in the Company by a single entity or person. The Company has recorded interest in the amount of \$51,780, which is included in interest expense in the accompanying statement of operations for the year ended June 30, 2005. The collateralized loan balance in the amount of

\$1.5 million is included as long-term debt in the accompanying balance sheet as of June 30, 2005.

The Company has agreed for a period equal to the shorter of (i) three years from the closing or (ii) such time as ComVest owns less than 5,000,000 shares of the Company's common stock, not to issue any shares of common stock, or any securities convertible into common stock for an effective per share price of less than \$0.25 per share, without the approval of ComVest. The Company also has agreed not to incur any indebtedness for borrowed money other than an asset-based senior line of credit without the prior approval of ComVest. The Company is obligated to use 50% of any proceeds it may receive in the future upon the sale of certain equity or debt securities to redeem outstanding Series C Convertible Preferred Stock or to retire the loan.

At the closing of the transaction, ComVest also received warrants to purchase another 2,000,000 shares at \$0.50; however, these warrants will become exercisable only if less than two ComVest designees are members of the Company's Board of Directors while ComVest owns more than 5,000,000 shares of the Company's common stock.

All warrants will be subject to anti-dilution protection and contain cashless exercise provisions.

At closing, the Company paid ComVest a cash fee of \$240,000, which was offset against the gross proceeds of the preferred and common stock.

Subject to waiver by the unanimous consent of the Company's Board of Directors, the Company has agreed to maintain a minimum cash balance of \$750,000. This cash is available for the Company to use but, in the event of its use, an event of default under the debt instrument would be triggered which, if left uncured, could result in the debt being declared immediately due and payable. As of June 30, 2005, the Company is in compliance with all covenants contained in the debt agreement.

Upon the closing of the financing transaction with ComVest, Delia MacIntosh, the spouse of the Company's former Chief Executive Officer, converted the remaining outstanding debt of the Company due to her in the aggregate amount of approximately \$400,000 into 2,704,000 shares of Common Stock at the same terms as the equity financing (see Note 7).

## **Korn/Ferry International (2005 Form 10-K)**

Example .

## 10. Convertible Mandatory Redeemable Securities

In June 2002, the Company issued 7.5% Convertible Subordinated Notes in an aggregate principal amount of \$40.0 million and 10,000 shares of 7.5% Convertible Series A Preferred Stock at an aggregate purchase price of \$10.0 million. As of April 30, 2006, 11,387 shares were authorized, issued and outstanding on our preferred stock. The notes and preferred stock have priority over common stockholders. The notes and preferred stock are convertible into shares of the Company's common stock at \$10.19 per share. The Company also issued warrants to purchase 274,207 shares of its common stock at an exercise price of \$11.94. The warrants expire in 2012. The warrants were recorded at fair value resulting in discounts on the notes and preferred stock (together "the securities") of \$1.2 million and \$0.3 million, respectively, and are amortized over the life of the securities. In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity," effective at the beginning of the first interim period after June 15, 2003. This Statement required mandatorily redeemable instruments be classified as liabilities. The Company adopted this Statement in the first quarter of fiscal 2004 and classified its convertible mandatorily redeemable preferred stock as a liability. The Company reported its accretion on redeemable preferred stock as interest expense in fiscal 2006, 2005 and 2004.

The securities may be redeemed at the option of the purchasers after June 13, 2008, the sixth anniversary of the closing date, at a price equal to 101% of the issuance price plus all accrued interest and dividends. The securities are mandatorily redeemable by the Company if still outstanding on June 13, 2010, at a price equal to 101% of the issuance price plus accrued interest and dividends. From the third to the sixth year, the securities are subject to optional redemption by the Company at 200% to 250% of the then outstanding principal balance.

Interest and dividends are payable semi-annually in either additional securities or cash at the option of the Company. The Company also incurred issuance costs of \$4.3 million that have been deferred and are being amortized over the life of the securities as interest expense with respect to \$3.4 million allocated to the notes and \$0.9 million allocated to the preferred stock.

## **Hexion Specialty Chemicals, Inc. (2005 Form 10-K)**

Example .

### 11. Redeemable Preferred Stock

In May 2005, Hexion Escrow Corp., a subsidiary of Hexion which merged into Hexion coincidental with the Combinations, offered 14 million shares of Redeemable Series A Floating Rate Preferred Stock, par value \$0.01 per share, and a liquidation preference of \$25 per share (the "Preferred Stock"). The Preferred Stock will accumulate cumulative preferential dividends from the issue date at an initial rate of LIBOR plus 8.0%, compounded semi-annually. The dividend rate increases 75 basis points every six months beginning November 15, 2005 until May 15, 2007, at which time the rate is LIBOR plus 11.0%. As of December 31, 2005, the dividend rate was 13.3%. Dividends will be paid by issuing additional shares of Preferred Stock through May 15, 2010. Thereafter, dividends will be required to be paid in cash. After November 15, 2005, the Company has the option to redeem all or a portion of the Preferred Stock at between 101% and 103% of the aggregate liquidation value plus accrued and unpaid dividends. On or after May 15, 2007, the Company may convert the Preferred Stock from a floating rate security to a fixed rate security, with dividends payable at an annual rate equal to 14.0%. On October 15, 2014, or upon a change in control of the Company, the Preferred Stock shareholders have the option to require the Company to repurchase all or a portion of the Preferred Stock. Because of this mandatory redemption clause, the Preferred Stock is considered a mezzanine financing and is recorded outside of Common Stock and Other Shareholder's Deficit.

The Company expects to use a portion of the proceeds it receives from its proposed IPO (See Note 1) to redeem the Preferred Stock. In the event that the Preferred Stock is not redeemed by November 15, 2006, the initial purchasers of the Preferred Stock are entitled to receive a rollover fee of 1.5% of the aggregate initial liquidation preference of the Preferred Stock held on that date, which will result in a cash payment of up to \$5. The net proceeds from the Preferred Stock issuance were \$334, after deducting underwriting expenses and expenses of the offering of \$16, and were used along with term loan debt borrowed under the Hexion Credit Facility to pay a dividend to its parent on May 31, 2005 (See Note 14). For presentation purposes, the issuance costs of \$16 offset the carrying amount of the Preferred Stock. These costs are amortized using the effective interest method from the issue date through October 15, 2014. For accounting purposes, the Preferred Stock is considered increasing rate preferred stock issued at an implied premium. As such, the implied premium is being accreted using the effective interest method from the issue date through May 15, 2007, which is the commencement of the perpetual dividend. For the year ended December 31, 2005, the Company recognized accreted dividends, including accretion of the implied premium, of \$30. During the fourth quarter of 2005 the Company issued 781,959 shares of preferred stock in payment of the first semi-annual dividend.

## Kana Software, Inc. (2005 Form 10-K)

### CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT) (In thousands, except share data)

Shares	Amount	Additional Paid-In	Deferred Stock-Based	Accumulated Other	Accumulated Deficit	Total Stockholders'
--------	--------	-----------------------	-------------------------	----------------------	------------------------	------------------------



income (loss):								
Foreign currency translation adjustment	-	-	-	-	421	421		
Net loss	-	-	-	-	-	(21,768)	(21,768)	
Total comprehensive income (loss)	=	=	=	=	=	=	<u>(21,347)</u>	
Balances at December 31, 2004	29,245,402	29	4,288,176	(58)	459	(4,285,442)	3,164	
Issuance of common stock upon exercise of stock options	14,480	-	22	-	-	-	22	
Adjustment	(19,910)	-	-	-	-	-	-	
Amortization of deferred stock- based compensation	-	-	(20)	58	-	-	38	
Issuance of common stock, net of fees	4,683,811	5	4,885	-	-	-	4,890	
Comprehensive income (loss):								
Foreign currency translation adjustment	-	-	-	-	58	-	58	
Net loss	-	-	-	-	-	(17,966)	(17,966)	
Total comprehensive income (loss)	=	=	=	=	=	=	<u>(17,908)</u>	
Balances at December 31, 2005	33,923,783	\$34	\$4,293,063	\$-	\$517	\$(4,303,408)	\$(9,794)	

## 12.5 RELATED TOPICS

Section 2 , Marketable Securities

Section 3 , Notes and Accounts Receivable

Section 10 , Notes Payable, Bonds, and Other Debt

Section 13 , Additional Paid-In Capital

Section 14 , Retained Earnings

Section 15 , Dividends

Section 16 , Treasury Stock

Section 25 , Earnings Per Share

Section 28 , Business Combinations

Section 39 , Financial Instruments, Derivatives, and Hedging Activities

Section 44 , Nonmonetary Transactions

Section 49 , Quasi-Reorganizations

Section 52 , Stock Option and Purchase Plans

Section 53 , Subsequent Events

Section 71 , International Financial Reporting Standards

© 2007 Thomson/RIA. All rights reserved.