FIGURE 11–2 A Report

B&H Financial Consultants
125 Easy Street
Athens, Georgia 30601
August 8, 2014

Mr. Sam Hamilton
Hamilton Manufacturing
1890 Meerly Avenue
Atlanta, Georgia 30306

Dear Mr. Hamilton:

Enclosed is the report about convertible bonds that you requested in your letter of July 21. The report, titled *Convertible Bonds: Financial and Accounting Considerations*, examines the nature of convertible debt, the pros and cons of such an issue, and the accounting treatment of the securities.

The report shows that convertible bonds may represent a relatively less expensive method of raising capital than nonconvertible bonds. Another advantage is that should the convertible bonds be converted, the existing shares of common stock will not be diluted as severely as they would if common stock had been issued. However, as the report makes clear, these effects are by no means certain.

I believe the report will provide you with the information you need. If you have any further questions, however, don't hesitate to give me a call.

Sincerely yours,

Joyce Samuels

Joyce Samuels
jhw

FIGURE 11-2 (*Contd.*)

CONVERTIBLE BONDS:
FINANCIAL AND ACCOUNTING CONSIDERATIONS

Prepared for Hamilton Manufacturing

by

JOYCE SAMUELS

AUGUST 8, 2014

FIGURE 11–2 (*Contd.*)

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FIGURE 11–2 (*Contd.*)

EXECUTIVE SUMMARY

This report provides information about convertible bonds for the managers of Hamilton Manufacturing. Included is information about the nature of convertible bonds, financial advantages and disadvantages of issuing such bonds, and their accounting treatment.

A convertible bond is a debt security that carries the option of exchange for an equity security, usually common stock. The bond indenture specifies when the bonds may be converted and a conversion ratio.

Convertible bonds would offer Hamilton several advantages:

- The company could issue the bonds at a premium or at a low stated interest rate, which investors would accept because of the conversion privilege.
- The company could avoid another stock issue now, when the price of Hamilton's stock is low.
- The company may avoid a decrease in share price caused by issuing a large number of new shares on the market at one time.
- Total stock issuance costs may be less.
- Management would avoid possible conflict with its major stockholders.

There are also potential disadvantages management should consider before issuing the convertible bonds:

- Before conversion, the uncertain conditions of the economy make a future increase in the market price of the company's stock uncertain. If conversion does not occur, Hamilton may have difficulty meeting the debt requirements.
- Bond conversion will reduce basic earnings per share. Conversion will also increase Hamilton's income tax liability because of the loss of interest expense.
- The required accounting treatment of convertible bonds may have an unfavorable effect on the company's financial statements: a high level of debt may be presented alongside a lowered diluted earnings per share (DEPS).

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FIGURE 11–2 (*Contd.*)

CONVERTIBLE BONDS:
FINANCIAL AND ACCOUNTING CONSIDERATIONS

Introduction

The purpose of this report is to provide information for the management of Hamilton Manufacturing about convertible debt as a means of financing. Convertible debt is an issue of debt securities (bonds) with the option to exchange those debt securities for equity securities (usually common stock).

This report covers three major topics:

- The nature of convertible bonds.
- Financial advantages and disadvantages Hamilton can expect if it issues the bonds.
- Accounting treatment for the bonds.

Nature of Convertible Bonds

When convertible bonds are issued, the bond indenture defines a time period after issuance during which the bonds may be converted. The indenture also gives a conversion ratio, which is the number of shares of stock for which each bond may be exchanged. The effective price of stock to the bondholder is determined by dividing the par value of the bond by the number of shares exchangeable for one bond.

The indenture usually includes a call provision so that the issuing entity can force bondholders to convert (usually at a premium over par). Thus, entities that issue convertible debt often do so as a means of raising equity capital. The following sections discuss why Hamilton might choose to issue convertible debt.

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FIGURE 11–2 *(Contd.)*

Financial Advantages and Disadvantages

Advantages

Use of convertible debt would offer Hamilton advantages over straight debt or stock issues.

Investors in bonds that are convertible into stock are usually willing to accept a lower stated interest rate on such bonds, to pay a premium and accept a lower yield, or to accept less restrictive covenants. Thus, by issuing convertible debt, Hamilton will probably be able to obtain funds at a lower cost than if it issued debt that is not convertible.

Depending upon economic conditions, there may also be a timing advantage to issuing convertible debt. If current conditions make it unfavorable to sell stock because of depressed value, issuing convertible debt will allow Hamilton to raise capital debt now that may later be converted into stock when the stock price has recovered.

In addition, by issuing convertible debt, Hamilton may avoid a decrease in stock price caused by a large new issue of stock being made available on the market all at once.

Another advantage to Hamilton of issuing convertible bonds is that the company might avoid creating a conflict with major stockholders, who want to maintain their percentage interests. The stockholders might vote against a large issue of stock. However, the bond issue could be convertible into a number of shares small enough not to significantly injure the stockholders' interests.

Disadvantages

Most disadvantages of issuing convertible bonds are related to the uncertainty of conversion. If Hamilton's stock price does not rise, conversion may not occur without call, the company may not obtain the equity financing it desires, and Hamilton might then be saddled with long-term debt obligations.

Another disadvantage is the impact on either diluted earnings per share (DEPS) before conversion, or basic earnings per share (BEPS) after conversion. In either case the earnings per share figure will be reduced. After conversion, income tax expense will increase because of the reduction in interest expense.

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FIGURE 11–2 (*Cont'd.*)

Accounting Treatment

According to Generally Accepted Accounting Principles (GAAP), if convertible bonds are "sold at a price or have a value at issuance not significantly in excess of the face amount . . . [n]o portion of the proceeds from the issuance . . . shall be accounted for as attributable to the conversion feature" (ASC pars. 470-20-25-10b and 470-20-25-12). In other words, the expectation that some or all of the bonds will be converted into stock is not recognized in the accounts.

Because convertible bonds are normally sold at a premium, the amount of the cash proceeds from the issue is usually greater than the face value of the bonds. The premium is amortized over the life of the bonds. The effect of the amortization is that the interest expense recorded by Hamilton each period would not equal the amount of the interest *payment*, but would reflect the effective yield to the bondholders.

When the bonds are converted, Hamilton will remove from the accounts the balance associated with those bonds. The value assigned to the stock equals the book value of the bonds, and no gain or loss is recognized or recorded (Kieso, Weygandt, and Warfield 2012, 907).

If Hamilton decides to retire its convertible bonds for cash before their maturity date, the transaction will be recorded in the same way as the early bonds, and the cash paid to retire them will be a gain or a loss on the income statement.

Although convertibles are accounted for solely as debt, Hamilton must also consider the equity characteristics of such issues in computing diluted earnings per share (DEPS). GAAP require that corporations having issued securities that are potentially dilutive of EPS, such as convertible bonds, must present both basic earnings per share (BEPS) and diluted earnings per share (DEPS) for income from continuing operations and for net income in the income statement "with equal prominence" (ASC par. 260-10-45-2).

The DEPS figure represents EPS *as if* the bonds had been converted into stock. If they had been converted, the removal of the bonds would have caused a reduction of interest expense, which would have increased earnings. However, the positive effect of the earnings adjustment may not offset the negative effect of the shares adjustment. Thus, convertibles reduce reported DEPS.

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FIGURE 11–2 (*Contd.*)

Conclusion

In deciding whether to finance with convertible debt, Hamilton must consider whether it would benefit from using convertibles rather than straight debt or stock issues and whether it can meet the debt requirements, should conversion not occur as expected. In addition, management should analyze carefully the effect of the issue on readers of the financial statements, because until the bonds are converted, a possibly high level of debt will exist alongside a lowered presentation of DEPS.

WORKS CITED

Financial Accounting Standards Board (FASB), 2013. *Accounting Standards Codification*®. Stamford, Conn.: FASB.

Kieso, Donald E., Jerry J. Weygandt, and Terry D. Warfield. *Intermediate Accounting*, 14th ed. Hoboken, NJ: John Wiley & Sons, Inc., 2012.

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