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Accounting Standard EITF 00-19 Now Top Priority for the SEC

Recently, many companies have been caught in an accounting problem relating to EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock." This guidance, issued by the Emerging Issues Task Force of the Financial Accounting Standards Board, has been in existence for several years. However, the Securities and Exchange Commission has just made enforcement of this standard one of its priority accounting issues and it appears to be catching the accounting industry and management off guard. This standard particularly impacts issuers of convertible securities where the conversion price does not have a floor. As such, small public companies that do PIPE transactions are among the most vulnerable to this issue.

EITF 00-19 requires many types of convertible equity instruments to be reclassified as liabilities in cases where the issuer's ability to settle the instrument in equity is not entirely within the issuer's control. The standard also requires the value of the instrument to be expensed and marked to market, so that future fluctuations of value will be reflected on the income statement.

Under EITF 00-19, companies that for years thought they raised equity are finding out they instead issued debt. According to the SEC's guidance, the most common cases where issuers do not have control to "net-share" settle these instruments are where the conversion price of a convertible instrument does not have a floor, and where issuers' registration rights agreements contain substantial liquidated damages penalties if the shares underlying the instrument are not timely registered.

The concept behind EITF 00-19 is logical in the sense that if a company's equity instrument cannot be settled simply in equity, then the company should have a financial liability on its books.

But do the guidance and the SEC's interpretation go too far? Per the guidance and the SEC, companies are not allowed to argue probability of an event occurring to avoid the guidance. Thus, even if a profitable company with a healthy stock price does not have a floor on a convertible security,

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the conversion feature must be booked as a liability. Similarly, even if a company has plenty of authorized shares to net-share settle an instrument all the way down to, say, a \$0.01 conversion price, if there is no floor on the theoretical conversion price, the instrument is a liability. Furthermore, even if a company definitely has enough available authorized stock to settle all of an instrument down to a certain conversion price, the guidance will not permit the issuer to bifurcate the instrument between the sure equity portion and the unknown liability portion. Worst of all, if any single one of a company's instruments must be classified as a liability under EITF 00-19, the SEC's interpretation requires that all other derivatives also be classified as liabilities.

The impacts are potentially devastating, especially to companies that have already issued these instruments and have not booked them correctly. Consequences include a decrease in a company's net worth (perhaps triggering credit facility covenant defaults), an immediate hit to earnings (disappointing investors and triggering credit facility defaults), and the expense and hassle of restated financials and refiled annual and quarterly reports.

The enforcement of EITF 00-19 may spell the end of floorless convertible securities. Meanwhile, companies with these securities outstanding have little choice but to comply. A company can avoid the going-forward implication of the guidance if the security holder will agree to amend the instrument to include a floor. However, an amendment will not eliminate the need to comply with the guidance retroactively through the date of amendment.

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If you have any questions about these issues or any other developments in the Corporate and Securities Practice or the Healthcare and Life Sciences Practice areas, please feel free to contact **Stephen R. Drake** at 312-499-1423 in the firm's **Chicago** office. Mr. Drake's e-mail address is sdrake@ebglaw.com.

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