

Case 05-7

Ace Company

Ace Company, a U.S. SEC registrant, was considering an offering of MEDS Equity Units in an effort to raise capital with a targeted issuance date of June 23, 2002. The CFO of Ace Company tells you that each MEDS Equity Unit consists of:

- A forward stock purchase agreement that requires the investor to purchase common stock of Ace Company in three years for \$50. The number of shares to be purchased depends on the market price of Ace Company's common stock at the time of settlement.
- A note payable by Ace Company, with a maturity of three years and six months. The interest rate payable is fixed for the first three years; at the end of the three years, the interest rate is reset and the note is remarketed to other investors. The note is pledged as collateral under the forward stock purchase agreement.

The CFO gives you a copy of the prospectus summary (attached as Exhibit 1), informing you that the investment bankers have confirmed that the interest rate on the note payable is equal to Ace Company's market rate (i.e., if Ace Company issued the notes payable separately, there would be no premium or discount). The investment bankers also assert that the likelihood of a failed remarketing of the notes is remote. The last reported sales price of Ace Company's common stock on the New York Stock Exchange was \$40.

Required:

In deciding how to account for the issuance of the MEDS Equity Units, address the following issues:

- Should the various components of each MEDS Equity Unit be accounted for separately? If so, how should Ace allocate the proceeds received among the components?
- Should each MEDS Equity Unit (if accounted for as one unit of account) or the components of the MEDS Equity Units (if accounted for separately) be accounted for as a derivative, or should any embedded derivatives be accounted for separately?