

Topic: Determining the Nature of a Host Contract Related to a Hybrid Financial Instrument Issued in the Form of a Share under FASB Statement No. 133

Date Discussed: March 15, 2007

The SEC Observer made the following announcement of the SEC staff's position relating to the determination of whether the characteristics of a host contract related to a hybrid financial instrument issued in the form of a share are more akin to a debt instrument or more akin to an equity instrument.

Consistent with paragraphs 12 and 60 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the SEC staff believes that the determination of the nature of the host contract for a hybrid financial instrument issued in the form of a share (that is, whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument) should be based on a consideration of economic characteristics and risks. The SEC staff also believes that in performing an evaluation of an embedded derivative feature under paragraph 12(a) of Statement 133, the consideration of the economic characteristics and risks of the host contract should be based on all of the stated or implied substantive terms and features of the hybrid financial instrument.¹ In evaluating the stated and implied substantive terms and features, the existence or omission of any single term or feature is not necessarily determinative of the economic characteristics and risks of the host contract (that is, whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument). Although the consideration of an individual term or feature may be weighted more heavily in the evaluation, judgment is required based upon an evaluation of all the relevant terms and features. For example, the SEC staff believes that the fact that a preferred stock contract without a mandatory redemption feature would be classified as temporary equity under Topic D-98 is not in and of itself determinative of the nature of the host contract (that is, whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument). Rather, the SEC staff believes that the nature of the host contract depends upon the economic characteristics and risks of the preferred stock contract.²

This staff announcement is limited to the SEC staff's position regarding the determination of whether a host contract related to a hybrid financial instrument issued in the form of a share is considered to be a debt instrument or an equity instrument for purposes of the evaluation of an embedded derivative (or multiple embedded derivatives) under paragraph 12(a) of Statement 133. It is not intended to address when an embedded derivative (or multiple embedded

¹ The "hybrid financial instrument" includes the terms and features pertaining to other embedded derivatives that are separately evaluated under paragraph 12 of Statement 133. However, the SEC staff understands that as an accounting policy some registrants exclude the terms and features pertaining to the individual embedded derivative being evaluated under paragraph 12 of Statement 133 in determining the nature of the host contract for that particular embedded derivative.

² The SEC staff does not believe the guidance pertaining to the paragraph 11(a) scope exception in Statement 133 Implementation Issue No. C2, "Application of the Exception to Contracts Classified in Temporary Equity," is applicable, by analogy, to the determination of the nature of the host contract under paragraph 12(a) of Statement 133.

derivatives) should be separated from the host contract under Statement 133 or the accounting under Statement 133 when such separation is required. Statement 133 and the related interpretative guidance in the Statement 133 Implementation Issues provide the relevant guidance for these matters. For example, Statement 133 Implementation Issue No. B19, "Identifying the Characteristics of a Debt Host Contract," provides guidance on how an entity determines the characteristics of a debt host contract once a conclusion has been reached that the host contract is a debt instrument.

Transition

A registrant may initially apply the guidance in this staff announcement to **all** of its affected outstanding hybrid financial instruments issued in the form of shares in a manner consistent with the transition provisions for embedded derivatives contained in Question 2 of Statement 133 Implementation Issue No. K5, "Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues," effective as of the first day of the first fiscal quarter beginning after June 15, 2007. In applying the guidance in this staff announcement, a registrant should report the adoption of the change in accounting principle at the beginning of the first fiscal quarter beginning after June 15, 2007, even if that period is other than the first fiscal quarter of the registrant's fiscal year.

Alternatively, the SEC staff will also not object to the application of the guidance in this staff announcement prospectively to **all** hybrid financial instrument contracts issued in the form of shares that are entered into, modified, or otherwise subject to a remeasurement (new basis) event in fiscal quarters beginning after June 15, 2007.

Earlier adoption of the aforementioned transition provisions is encouraged; however, previously issued financial statements should not be retrospectively adjusted.