FASB Emerging Issues Task Force

Issue No. 13-G

Title: Determining Whether the Host Contract in a Hybrid Financial Instrument Is More Akin to Debt or to Equity

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FASB Staff: Milone (203.956.5344) / Or (203.956.5212)

EITF Liaison: Mark Bielstein

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Background

1. Under Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives, an entity that issues or invests in a hybrid financial instrument, which is defined in the Master Glossary as "A contract that embodies both an embedded derivative and a host contract," is required to bifurcate an embedded derivative from the host contract and account for the feature as a derivative pursuant to Subtopic 815-10, Derivatives and Hedging—Overall, if certain criteria are met. One criterion in paragraph 815-15-25-1(a) is that the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract. When determining whether an embedded derivative is clearly and closely related to the host contract, an entity must first determine the nature of the host contract; for example, whether the host contract is more akin to debt or to equity. If the host contract is akin to equity, then equity-like features (for example, a conversion option) are considered clearly and closely related to the host contract, and thus would not be bifurcated from the host (that is, no separate derivate accounting would be necessary for the feature). If the host contract is akin to

* **The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

debt, then equity-like features are not considered clearly and closely related to the host. In the latter case, an entity may be required to bifurcate the equity-like embedded derivative feature from the debt host contract if certain other criteria are met (and, if so, account for the feature as a derivative, marking it to fair value each reporting period with changes in the fair value flowing through the income statement).

2. The staff received feedback indicating diversity in practice with respect to the methods used in evaluating the nature of the host contract; the use of different methods can result in different accounting outcomes for economically similar instruments. Some stakeholders further suggested that additional interpretative guidance may be beneficial for preparers in evaluating (and weighting) the various terms and features in an instrument, particularly regarding how much weight should be given to redemption features in a hybrid financial instrument that is in the form of a share (for example, convertible and redeemable preferred stock). This Issue Summary analyzes the various methods used and lays out alternatives for how U.S. GAAP can provide further guidance on evaluating the redemption features. The scope of this Issue Summary includes hybrid financial instruments that are issued in the form of a share (consistent with the scope of SEC Staff Announcement, EITF Topic No. D-109, "Determining the Nature of a Host Contract Related to a Hybrid Financial Instrument Issued in the Form of a Share Under Topic 815" (formerly under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and codified in paragraph 815-10-S99-3) (EITF Topic D-109) from the perspective of both the issuers of and investors in such instruments.

3. One topic that may need to be addressed as part of the deliberations is whether Issue 1 of this Issue Summary should apply to other hybrid instruments, such as convertible debt or nonfinancial hybrid instruments. The EITF Agenda Committee recommended that the scope of this Issue initially be set narrowly (as noted above), with the understanding that the scope could become broader in the future, if warranted.

4. Determining whether the host contract in certain instruments, such as a convertible preferred equity instrument with a fixed-price redemption option held by the investor, is more akin to debt or to equity requires judgment because such instruments often have characteristics of both debt

and equity. The current accounting guidance governing that analysis is discussed in the Codification in paragraphs 815-15-25-16 and 25-17, and is as follows:

> If the host contract encompasses a residual interest in an entity, then its economic characteristics and risks shall be considered that of an equity instrument and an embedded derivative would need to possess principally equity characteristics (related to the same entity) to be considered clearly and closely related to the host contract. However, most commonly, a financial instrument host contract will not embody a claim to the residual interest in an entity and, thus, the economic characteristics and risks of the host contract shall be considered that of a debt instrument.
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> Because the changes in fair value of an equity interest and interest rates on a debt instrument are not clearly and closely related, the terms of convertible preferred stock (other than the conversion option) shall be analyzed to determine whether the preferred stock (and thus the potential host contract) is more akin to an equity instrument or a debt instrument. A typical cumulative fixed-rate preferred stock that has a mandatory redemption feature is more akin to debt, whereas cumulative participating perpetual preferred stock is more akin to an equity instrument.

5. The staff of the U.S. Securities and Exchange Commission also provided incremental guidance related to the determination of the nature of the host contract for instruments issued as equity in legal form (for example, convertible preferred instruments). In EITF Topic No. D-109, the SEC staff stated, in part:

> Consistent with Section 815-15-25, 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… should be based on a consideration of economic characteristics and risks…. [and] should be based on all of the stated or implied substantive terms and features of the hybrid financial instrument.FN1 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…. 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 paragraph 480-10-S99-3A is not in and of itself determinative of the nature of the host contract.... Rather, the SEC staff believes that the nature of the host contract depends upon the economic characteristics and risks of the preferred stock contract. [FN2 omitted.]
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> FN1 The "hybrid financial instrument" includes the terms and features pertaining to other embedded derivatives that are separately evaluated under paragraph 815-15-25-1. 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 815-15-25-1 in determining the nature of the host contract for that particular embedded derivative.

6. The FASB staff notes that at the time EITF Topic D-109 was announced, it was generally understood that the concern addressed by the SEC staff was that certain preparers were disregarding some or all of the terms and features of certain preferred equity instruments, and concluding that the host contract was more akin to equity based largely on legal form. As a result, EITF Topic D-109 was intended to clarify the SEC staff's view that the evaluation of the host contract should be based on **all** of the stated or implied substantive terms and features of the hybrid financial instrument.

7. As noted in the footnote to EITF Topic D-109, however, the SEC staff also acknowledged at the time the use of an alternative method in practice in which some registrants, as an accounting policy, exclude the terms and features pertaining to the individual embedded derivative being evaluated under paragraph 815-15-25-1 in determining the nature of the host contract for that particular embedded derivative.

8. The FASB staff understands that there are two methodologies that exist in practice (the so-called whole-instrument approach and the chameleon approach). In addition, a third approach (the so-called pure-host approach) has been advocated by some who believe that it is the approach that is the most consistent with the principles of Topic 815. The three approaches are described below:

> *Whole-Instrument Approach*
> Under the whole-instrument approach, an entity determines the nature of a host contract considering **all** of the terms and features of the hybrid financial instrument and then individually compares each embedded derivative feature to the host contract to determine

whether the embedded derivative feature is clearly and closely related to the host contract.

Chameleon Approach
Under the chameleon approach, an entity determines the nature of a host contract considering all of the terms and features of the hybrid financial instrument **except** for the embedded derivative feature being evaluated for bifurcation. This evaluation is performed individually for each embedded derivative feature. As such, if the hybrid financial instrument contains multiple embedded derivative features, the nature of the host contract may change as each feature is separately evaluated.

Pure-Host Approach
Under the pure-host approach, an entity determines the nature of the host contract by excluding all embedded derivative features. All remaining terms and features would be analyzed to determine the nature of the host contract. An entity would then individually compare each embedded derivative feature to the host contract to determine whether the embedded derivative feature is clearly and closely related to the host contract.

9. Consider, as an example, convertible preferred stock with the following terms ("Hybrid Share #1"):

- Stated value: $100 (equal to the original issuance price)
- Maturity date: No stated maturity
- Conversion option: Investors may convert Hybrid Share #1 at any time into common stock of the issuer on a one-for-one basis[1]
- Dividend rights: Investors participate in any dividends paid on the issuer's common stock on an "as-converted" basis
- Voting rights: Investors have a right to vote with the issuer's common shareholders on an "as-converted" basis
- Redemption option: Investors may redeem Hybrid Share #1 for $100 (the stated value and original issuance price) any time after the fifth anniversary of the issuance date.[2]

[1] Assume that the effective conversion price of the conversion option is other than "deep-in-the-money" at the time of issuance considering the life of the option.

[2] A common feature added to the redemption option is that the investor may redeem each hybrid share for the greater of a fixed amount or the fair value of the common shares into which the hybrid instrument may be converted. In effect, the conversion option can be cash-settled and, thus, whether the conversion option must be bifurcated is heavily dependent on the determination of the nature of the host contract.

10. The FASB staff understands that when determining whether the conversion option embedded within Hybrid Share #1 is clearly and closely related to the host contract, most preparers applying the chameleon approach conclude that the host contract is a debt host and that the conversion option is not clearly and closely related to the host contract.[3] When excluding the conversion option, but taking into consideration all other terms of the hybrid instrument, those entities argue that the fixed-price redemption option held by the investor causes the host contract to be more akin to debt. That is, those preparers believe that as a result of the redemption option, the host contract does not encompass a true residual interest in the issuer because the investor may not be fully exposed to negative movements in the value of the issuer's equity. See Appendix 13-GA for a more detailed clearly and closely related analysis.

11. When applying the whole-instrument approach, the FASB staff understands diversity in practice exists when determining the nature of the host contract within Hybrid Share #1. Some entities might consider all terms of the hybrid instrument and find that the equity-like features (for example, voting rights, dividend participation rights, and conversion option) indicate that the host contract is more akin to equity even though it includes what some would argue is a debt-like fixed-price redemption option (or that a redemption option and conversion option might "offset" each other in the analysis, indicating that the host contract is more akin to equity because the remaining characteristics are equity-like). Other entities place significant weight on the fixed-price redemption option held by the investor and conclude that the host is debt-like on that basis. See Appendix 13-GA for a more detailed clearly-and-closely-related analysis.

12. The FASB staff understands that for the purpose of determining the nature of the host contract within hybrid instruments issued in the form of a share (for example, Hybrid Share #1), the pure-host approach is not currently used in practice. However, the FASB staff understands that the pure-host approach is a method that is used by some in practice for hybrid instruments not issued in the form of a share. Under a pure-host approach, where the conversion feature and redemption option in Hybrid Share #1 would be excluded from the determination of the host

[3] Similar analysis may be performed to determine whether the redemption option should be bifurcated. That is, under the chameleon approach, the hybrid share host contract may be determined to be more akin to equity. Under that scenario, an entity would then determine whether the other criteria for bifurcation are met, including whether a separate instrument with the same terms as the redemption option would be a derivative subject to Subtopic 815-15.

contract, it is likely that entities would conclude that the nature of the host contract is more akin to equity (because the remaining features are equity-like). See Appendix 13-GA for a detailed clearly-and-closely-related analysis.

Accounting Issues and Alternatives

Issue 1: Whether to (a) consider all of an instrument's terms and embedded derivative features (that is, use a whole-instrument approach), (b) exclude the embedded derivative feature being evaluated (that is, use a chameleon approach), or (c) exclude all embedded derivative features (that is, use a pure-host approach) when determining the nature of the host contract.

13. Issue 1 applies to both issuers of and investors in hybrid financial instruments that are issued in the form of a share. The scope of Issue 1 is intended to be aligned with the scope of EITF Topic D-109.

14. Issue 1 addresses whether the whole-instrument approach, the chameleon approach, or the pure-host approach are acceptable to use when determining the nature of the host contract within a hybrid financial instrument issued in the form of a share (both from an issuer and investor perspective).

View A: The whole-instrument approach should be used when determining whether the host contract within a hybrid financial instrument issued in the form of a share is more akin to debt or to equity.

15. Proponents of View A believe that it is not appropriate to disregard any feature in the analysis of the economic characteristics and risks of the host contract because the instrument's cash flows ultimately are dependent upon the interaction among all contractual provisions within the instrument and the way in which an investor or issuer may exercise options within the contract.

16. Proponents of View A believe that the whole-instrument approach is consistent with EITF Topic D-109, which states that "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" (emphasis added). While footnote 1 of EITF Topic D-109 includes the SEC staff's observation that some entities exclude the terms and features pertaining to the individual embedded derivative being evaluated, the SEC staff makes no observation in that footnote about the appropriateness of that approach (that is, the chameleon approach).

17. Proponents of View A also note that, unlike the chameleon approach, the whole-instrument approach only requires a single analysis of the nature of the host contract. Therefore, the nature of the host contract is only determined once and, as such, would not change based on which embedded derivative feature is being analyzed. Proponents of View A believe that it is not appropriate for a host contract to change its nature depending on which embedded derivative feature is being evaluated.

18. Opponents of View A observe that the whole-instrument approach could result in situations in which an embedded derivative feature is, in effect, found to be clearly and closely related to itself. Consider Hybrid Share #1 described in the example above. When applying the whole-instrument approach, an entity may conclude that the convertible preferred equity instrument is more akin to equity. That is, the conversion option gives the investor the right to participate in the potential payoff and risks of the instrument on an "as-converted" basis, making the instrument more akin to equity when considered with other relevant features of the instrument.

19. Under that analysis, the equity-like conversion option is found to be clearly and closely related to the equity-like host contract, but the primary reason the host contract was equity-like was because of the feature being analyzed. In that way, the conversion option is clearly and closely related to itself. Opponents of View A question whether such an approach achieves the objective of the clearly and closely related analysis, which they believe is to compare the risks associated with the embedded derivative feature and related timing and amount of cash flows with that of the instrument as if the embedded derivative feature had not been added to the contract.

20. Opponents of View A also cite paragraph 815-15-25-17, which states in the example that "the terms of convertible preferred stock **(other than the conversion option)** shall be analyzed to determine whether the preferred stock (and thus the potential host contract) is more akin to an equity instrument or a debt instrument" (emphasis added). That guidance suggests that a chameleon approach is required (at least when analyzing the conversion option).

21. Opponents of View A also observe that achieving comparability may be difficult under this view without adding additional implementation guidance. They note that diversity in practice exists among entities using the whole-instrument approach. When incorporating all of the features of a convertible preferred equity instrument into an assessment of whether the instrument is more akin to debt or to equity, entities do not have clear guidance within U.S. GAAP describing how much weight should be given to different features. Issue 2 of this Issue Summary discusses that point further.

View B: The chameleon approach should be used when determining whether the host contract within a hybrid financial instrument issued in the form of a share is more akin to debt or to equity.

22. Proponents of View B believe that the chameleon approach appears consistent with the overall objective of the embedded derivative analysis (that is, to compare the risks associated with the embedded derivative feature and related timing and amount of cash flows with that of the instrument as if the embedded derivative feature had not been added to the contract). In addition, proponents argue that this View avoids the potential for situations in which an entity may conclude that an embedded derivative feature is clearly and closely related to the host primarily because of the embedded derivative itself.

23. Proponents of View B observe that the chameleon approach is consistent with the guidance in paragraph 815-15-25-17 and with footnote 1 of EITF Topic D-109 (paragraph 815-10-S99-3).

24. Opponents of View B observe that paragraph 815-10-S99-3 requires entities to consider **all** substantive terms and features when determining whether a convertible preferred equity instrument is more akin to debt or to equity. They are also concerned about ignoring economic relationships among the different terms and features of the hybrid instrument.

25. Opponents of View B also believe that the chameleon approach is unnecessarily complex in some circumstances. That is because it requires that an entity perform a separate assessment of the host for each embedded derivative. As a result, the host contract can change depending on the feature being analyzed. Opponents of View B believe that it is not appropriate for a host contract to change its nature depending on which embedded derivative feature is being evaluated. The chameleon approach may result in the bifurcation of a compound derivative that has both debt and equity characteristics and/or a host contract subsequently accounted for separately that includes both debt and equity characteristics.

26. In addition, opponents of View B observe that achieving comparability may be just as difficult under View B without additional implementation guidance as noted in the discussion of View A. They note that there is also potential for diversity in practice among entities using the chameleon approach. When incorporating all the features of a convertible preferred equity instrument, except for the one being evaluated, into an assessment of whether the instrument is more akin to debt or to equity, entities do not have clear guidance within U.S. GAAP on how much weight should be given to different features (for example, when the redemption feature is not being evaluated for bifurcation and thus is part of a host contract under the chameleon approach). Issue 2 of this Issue Summary discusses that point further.

View C: The pure-host approach should be used when determining whether the host contract within a hybrid financial instrument issued in the form of a share is more akin to debt or to equity.

27. Proponents of View C believe that including embedded derivative features when defining the host contract is inconsistent with the objective of the clearly and closely related analysis, which they believe is to compare the risks associated with the embedded derivative feature and

related timing and amount of cash flows with that of the instrument as if the embedded derivative features had not been added to the instrument.

28. Proponents of View C believe that including embedded derivative features when determining the nature of the host contract is inconsistent with the guidance in paragraphs 815-15-05-1, 815-15-25-1, and 815-15-35-2A, which they believe illustrate the concept that a hybrid instrument consists of a host contract **plus** the embedded derivative feature(s). In addition, they point to the Master Glossary in the Codification, which defines a hybrid instrument as, "A contract that embodies an embedded derivative **and** a host contract" (emphasis added). They believe that this guidance indicates that the host contract is separate and distinct from the embedded derivative features, and, thus, the determination of the nature of the host contract should not consider embedded derivative features. Proponents of this view argue that if embedded derivative features are considered in the analysis, entities would actually determine the nature of the hybrid instrument (not the host contract).

29. Proponents of View C look to the guidance in paragraphs 815-15-25-1 and 815-15-25-16, which uses language that requires the evaluation of an embedded derivative feature against the "host contract" (not the "hybrid instrument") when performing the clearly and closely related analysis. They argue that under the whole-instrument approach (in all cases) and the chameleon approach (in cases in which the hybrid financial instrument contains multiple embedded derivatives), entities would be evaluating the economic characteristics and risks of the embedded derivative feature against the economic characteristics and risks of the "hybrid instrument," as opposed to the "host contract" (which they believe is in conflict with the guidance in paragraphs 815-15-25-1 and 815-15-25-16).

30. Opponents of View C argue that it is not appropriate to disregard all embedded derivate features in the analysis of the economic characteristics and risks of the host contract because the instrument's cash flows ultimately result from the interaction among all contractual provisions within the instrument and the way in which an investor or issuer may exercise options within the instrument.

31. Opponents of View C also argue that excluding embedded derivative features when defining the host contract would be inconsistent with EITF Topic D-109 (paragraph 815-10-S99-3), which states that "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" (emphasis added).

View D: In the absence of a broader liability/equity project, the whole-instrument, chameleon, and pure-host approaches (or some combination thereof) should be permitted when determining whether the host contract within a hybrid financial instrument issued in the form of a share is more akin to debt or to equity.

32. Proponents of View D observe that the SEC staff acknowledges both the whole-instrument and chameleon approaches in paragraph 815-10-S99-3 and footnote 1 of that paragraph. In addition, proponents of View D observe that there is conceptual merit to, and accounting guidance supporting, all three approaches as discussed above. Others believe that the pure-host approach should be precluded but that use of the other two approaches, which are common in practice, the whole-instrument and the chameleon approaches, should continue to be allowed as long as they are applied consistently as an accounting policy.

33. Those who support View D question whether one approach should always be used over the others. They believe that the context of the issuance, as well as the specific facts and circumstances of the transaction, should be considered in determining which approach most faithfully (a) represents the economics of the transaction and (b) meets the objective of the embedded derivative analysis.

34. Opponents of View D observe that the use of various approaches has led to diversity in practice and, thus, a decline in comparability among financial statement preparers that have issued convertible preferred equity instruments. They also believe that having multiple approaches used in practice does not serve to reduce complexity. In addition, they believe that allowing alternative approaches within the same entity would compound diversity and complexity.

Issue 2: How an entity should determine the nature of the host contract when an investor in a convertible preferred equity instrument holds a non-contingent, fixed-price redemption option?

35. Issue 2 applies to both issuers of and investors in hybrid financial instruments that are issued in the form of a convertible preferred share with a non-contingent, fixed-price redemption option held by the investor.

View A: There is a rebuttable presumption that the presence of a non-contingent, fixed price redemption option held by the investor embedded in a convertible preferred equity instrument is determinative in concluding that the host instrument is debt-like.

36. Proponents of View A believe that the potential downside protection provided by a non-contingent, fixed-price redemption option held by the investor generally causes the economic characteristics and risks of the host contract to be more akin to debt even when the hybrid instrument includes other terms and features that are equity-like, such as dividend participation rights, voting rights, or a conversion option. That is, there should be a rebuttable presumption that the host contract is debt-like because the fixed-price redemption option held by the investor may change the pay-off profile of the instrument such that the investor is not exposed to the residual risks of an equity investment. For example, investors in Hybrid Share #1 will participate with the issuer's common shareholders in dividends (that is, through the participating dividend rights) and positive movements in the issuer's stock price (that is, through the conversion option), but are potentially not exposed to all downside risks associated with a residual interest in the issuer. For purposes of this assessment, the staff interprets "non-contingent, fixed-price redemption feature" to mean redeemable anytime at a fixed or formula-based price at the discretion of the investor except due to (a) laws restricting redemption, (b) time restrictions stated in the redemption agreement, or (c) non-substantive contingent events that are remote of occurring.

37. EITF Topic D-109 states in part that "the existence or omission of any single term or feature is not necessarily determinative of the economic characteristics and risks of the host contract…the consideration of an individual term or feature may be weighted more heavily in the evaluation…." Proponents of View A believe that this guidance should be interpreted to indicate that certain features should be given more weight and that a non-contingent, fixed-price redemption option held by the investor should generally lead to concluding that the host contract is more debt-like.

38. Further, proponents of View A believe that the definition of "equity" in FASB Concepts Statement No. 6, *Elements of Financial Statements*, is relevant when evaluating whether the host contract "encompasses a residual interest" in the issuer. Specifically, paragraphs 50 and 60 of Concepts Statement 6 state, in part:

> The equity or net assets of both a business enterprise and a not-for-profit organization is the difference between the entity's assets and its liabilities. It is a residual, affected by all events that increase or decrease total assets by different amounts than they increase or decrease total liabilities. Thus, equity or net assets of both a business enterprise and a not-for-profit organization is increased or decreased by the entity's operations and other events and circumstances affecting the entity. [Footnote reference omitted.]
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> Since equity ranks after liabilities as a claim to or interest in the assets of the enterprise, it is a residual interest: (a) equity is the same as net assets, the difference between the enterprise's assets and its liabilities, and (b) equity is enhanced or burdened by increases and decreases in net assets from nonowner sources as well as investments by owners and distributions to owners. [Footnote references omitted.]

39. Concepts Statement 6 indicates that a residual interest in an entity exposes the holder to both positive and negative changes in the entity's net assets. As a non-contingent, fixed-price redemption option potentially protects investors from negative changes in the issuer's net assets, proponents of View A believe that it would be difficult to argue that the host contract is considered a residual interest in the issuer and, therefore, believe that the host contract would generally be deemed a debt host.

40. Proponents of View A note that the rebuttable presumption that a non-contingent, fixed price redemption option held by the investor would generally cause the host contract to be more akin to debt may be overcome depending on the facts and circumstances of the specific transaction (for example, if exercise of the non-contingent, fixed price redemption feature is deemed remote of occurring or is otherwise non-substantive). For example, an entity may look at the various circumstances in which the non-contingent, fixed price redemption option would be exercised. If the circumstances in which the non-contingent, fixed price redemption option would be exercised are deemed remote of occurring, an entity may be able to overcome the presumption of a debt host. The FASB staff recognizes that a likelihood-based assessment of a redemption feature on the date a convertible preferred stock is granted can require significant judgment. Such an assessment would have to consider the specific terms and features of the hybrid instrument and other factors, as follows:

a. Is redemption date-certain?
b. Is conversion date-certain?
c. Is conversion more likely to occur before redemption, for example, because of an expected IPO or change-in-control event?
d. Is the redemption price (formula) more favorable to the investor than the conversion price (formula)?
e. Are there laws that would significantly restrict the investor's ability to exercise the redemption feature (for example, if redemption would make an entity insolvent)?
f. Are there significant economic disincentives for the investor to exercise the redemption feature?

41. Proponents of View A argue that establishing a rebuttable presumption would help reduce complexity and diversity in practice, because it would establish the principle that a non-contingent, fixed-price redemption option is the most important feature when determining the nature of the host contract. Proponents believe that the lack of guidance regarding the potential weighting of various features in instruments such as Hybrid Share #1 has led to and would continue to lead to different entities coming to different conclusions for similar instruments regarding the nature of the host contract.

42. Opponents of View A argue it is incorrect to presume that the redemption option will allow the holder of the preferred share to exercise the redemption option and collect the redemption amount. For example, if the issuer does not have sufficient capital, the issuer would be unable to redeem the security even if the investor exercised the redemption option. That is because under various state laws and corporate charters, a preferred share cannot be redeemed if it would cause the issuer to become insolvent. In other words, if the preferred share was redeemed, the investor would receive an unsecured obligation that is subordinated to all secured and unsecured creditors. Thus, in reality, the investor in that security is potentially exposed to the residual risks (that is, negative movements) of an equity investment. That is especially true for some smaller issuers for whom those preferred shares are often the only substantive source of equity financing for the issuer.

43. In addition, opponents of View A argue that for many private issuers of preferred shares, in most cases, the company is either going to perform well and go public (in which case the conversion option would be exercised) or the company is going to perform poorly (in which case the preferred shareholders would effectively be the residual interest holders, as described in the paragraph above). Therefore, opponents argue that in a vast majority of circumstances, the redemption option will not be exercised and/or will not provide the downside protection that proponents of View A believe it will.

44. Opponents of View A argue that the language in EITF Topic D-109, which reads, "… the existence or omission of any single term or feature is not necessarily determinative of the economic characteristics and risks of the host contract," indicates that it should not be presumed (whether the presumption is rebuttable or not) that the non-contingent, fixed-price redemption option held by the investor causes the host contract to be debt-like. Some weight must be given to the other relevant terms and features. Opponents also believe that an entity must consider all substantive terms and features of the host contract. For example, the equity-like economic characteristics in Hybrid Share #1 created by the dividend participation rights, conversion option, and voting rights would also be considered when evaluating whether the conversion option is clearly and closely related to the host contract under the whole-instrument approach. Opponents

of View A believe that to presume those features are unimportant would contradict EITF Topic D-109.

View B: There should not be a rebuttable presumption that the presence of a non-contingent, fixed-price redemption option held by the investor embedded in a convertible preferred equity instrument is determinative in concluding that a host contract is debt-like. An entity would determine the nature of the host contract of a convertible preferred equity instrument by considering all relevant terms and features, weighing each feature based on relevant factors.

45. Proponents of View B believe that, consistent with the EITF Topic D-109, the "existence or omission of any single term or feature is not necessarily determinative of the economic characteristics and risks of the host contract," and that an entity should base its analysis on "all of the stated or implied substantive terms and features of the hybrid financial instrument." Proponents also argue that View B allows for the consideration of the context of the issuance and the specific facts and circumstances surrounding the transaction (for example, depending on facts and circumstances, it may not be appropriate for a redemption option to always be weighted more heavily than a conversion option, or vice versa).

46. Proponents of View B acknowledge that EITF Topic D-109 does not prescribe how to incorporate the conversion option into the host contract analysis, but paragraph 815-15-25-17 uses the phrase "excluding the conversion feature," which they acknowledge is a potential conflict (that is, EITF Topic D-109 appears to indicate that all terms and features of the hybrid instrument, which would include the conversion option, should be included in the host contract analysis, while paragraph 815-15-25-17 appears to explicitly state that the conversion option should be excluded from the analysis). Proponents of View B, however, do not believe that paragraph 815-15-25-17 is intended to preclude consideration of all the features.

47. Proponents of View B also look to paragraph 815-15-25-20, which discusses whether a put option that enables the investor to require the issuer of an equity instrument to reacquire that equity instrument is clearly and closely related to the equity host contract. The example concludes that the put option is not considered to be clearly and closely related to the equity host

contract. They believe that the existence of such an example in Topic 815 implies that a host contract may be considered equity-like, even when an embedded put option held by the investor is present in the instrument.

48. Opponents for View B argue that much of the diversity in practice arises as a result of entities considering all relevant terms and features, weighing each feature based on relevant factors, and coming to different conclusions. Therefore, opponents believe that a rebuttable presumption would provide more determinative guidance and reduce diversity. Even if the Task Force does not prefer the rebuttable presumption approach under View A, opponents of View B believe that the Task Force should still provide additional guidance for weighing various features (for example, redemption, dividends, voting rights, covenants, and conversion rights) to determine the nature of the host contract.

49. Opponents believe that View B is inconsistent with the guidance in paragraph 815-15-25-1(a), which specifically requires a consideration of both "economic characteristics and **risks**" (emphasis added). They believe that View B considers economic characteristics but would not appropriately emphasize the potential downside risk protection offered by the non-contingent, fixed-price redemption option held by the investor. Opponents believe that such potential downside risk protection is important and therefore substantive regardless of the likelihood of the redemption option being exercised.

Transition

View A: The effects of initially adopting the guidance in this Issue as of the effective date should be reported as a cumulative-effect adjustment directly to retained earnings as of the beginning of the year of adoption.

50. View A would provide similar transition guidance as several previous embedded derivative issues (for example, DIG Issues B38, B39, and C22), which required a modified retrospective application to all existing instruments as of the effective date via a cumulative-effect adjustment to retained earnings.

51. For a hybrid financial instrument that is required to be separated into a host contract and a derivative instrument as a result of applying the guidance in this Issue, the effects of initially complying with the guidance in this Issue as of the effective date should be reported as a cumulative-effect adjustment directly to retained earnings for the period of adoption. The carrying amount of the host contract at the effective date of this Issue would be based upon a pro forma bifurcation as of the date the entity issued or acquired the hybrid financial instrument, and the host contract's subsequent accounting to the effective date. At the effective date of this Issue, the transition adjustment would be the difference between the total carrying amount of the individual components of the newly bifurcated hybrid instrument and the carrying amount of the combined hybrid financial instrument prior to bifurcation.

52. If an entity had bifurcated an embedded derivative but is no longer required to do so as a result of applying the guidance in this Issue, the carrying amount of the related hybrid financial instrument at the guidance's effective date would be the total carrying amount of the host contract and the fair value of the previously bifurcated embedded derivative.

53. If a hybrid financial instrument would be required to be separated into a host contract and a derivative instrument as a result of applying the guidance in this Issue, the entity may irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings). The fair value election shall be determined on an instrument-by-instrument basis and supported by documentation completed by the end of the fiscal quarter of initial adoption.

54. Under View A, entities would also be provided with the alternative of applying the guidance in this Issue on a full retrospective basis (as outlined in View B below).

55. There would be no additional transition disclosures other than those required in paragraphs 250-10-50-1 through 50-3.

View B: The effects of initially complying with the guidance in this Issue as of the effective date should be applied on a retrospective basis for all periods presented.

56. View B would provide for consistent use of the same accounting methodology from one historical accounting period to another, which enhances the comparability of financial statements between periods.

57. For a hybrid financial instrument that is required to be separated into a host contract and a derivative instrument as a result of applying the guidance in this Issue, the guidance would be applied retrospectively. If in applying this guidance retrospectively the entity must recombine a host contract with a previously bifurcated embedded derivative, that entity would reverse any changes in the fair value of the embedded derivative that were previously recognized in income.

58. If it is deemed impracticable to apply the guidance in this Issue retrospectively, an entity would be permitted to apply the modified retrospective methodology outlined in View A.

59. There would be no additional transition disclosures other than those required in paragraphs 250-10-50-1 through 50-3.

View C: The effects of initially complying with the guidance in this Issue as of the effective date should be applied on a prospective basis.

60. View C would require a prospective application of the guidance in this Issue to all hybrid financial instruments issued or acquired after the effective date of this Issue, with recognition of the effect of the guidance in the period of adoption and future periods. The accounting for hybrid financial instruments existing as of the effective date of this Issue would not be affected by the guidance in this Issue.

61. Under View C there may be a lack of comparability within an entity's financial statements because similar instruments may be accounted for differently depending on when such instruments were issued or acquired (for example, before or after the adoption of the guidance in this Issue). However, View C would be the least complex and costly transition method.

62. There would be no additional transition disclosures other than those required in paragraphs 250-10-50-1 through 50-3.

Interaction with Current FASB Projects

63. The February 2013 proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, would eliminate the requirement to bifurcate embedded derivative features from a financial asset, but potential bifurcation of embedded derivative features from a financial liability would continue to be assessed. The embedded derivative features in a financial asset could affect the classification, and therefore the measurement, of the entire financial asset (that is, certain embedded derivative features may require the entire hybrid financial instrument to be classified at fair value through profit and loss).

Appendix A - Matrix Illustrating Interaction Between Issue 1 and Issue 2 of this Issue Summary (Based on Terms of Hybrid Share #1 Outlined in Paragraph 9)

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="2">Issue 2</th></tr>
<tr><th>View A: Rebuttable Presumption That a Non-Contingent, Fixed-Price Redemption Option Held by the Investor Is Determinative</th><th>View B: Weight All Relevant Terms and Features</th></tr>
<tr><td>Issue 1</td><td>View A: Whole-Instrument Approach</td><td>It depends, but there is a rebuttable presumption that the potential downside protection provided by a non-contingent, fixed-price redemption option held by the investor would cause the economic characteristics and risks of the host contract to be more akin to debt even when the hybrid instrument includes equity-like terms and features such as dividend participation rights, voting rights, or a conversion option. For this analysis, assume the entity concludes that the presumption cannot be overcome.

<u>Redemption Option</u>: Per paragraphs 815-15-25-26 and 815-15-25-40 through 25-42, the embedded put option held by the investor would be considered clearly and closely related to the debt host contract. As such, the embedded put option would not require bifurcation by either the issuer or investor.

<u>Conversion Option</u>: The conversion option is an equity derivative embedded in a debt-host contract. Per paragraph 815-15-25-51, the conversion option would not be considered clearly and closely related to the debt host. The issuer and investor would need to analyze the remaining requirements in paragraphs 815-15-25-1(b) and (c) to determine whether bifurcation and fair value accounting of the conversion option is required. The issuer may be able to avoid bifurcation and fair value accounting for the conversion option if it qualifies for the scope exception provided for in</td><td>It depends.

An entity would determine the nature of the host contract of a convertible preferred equity instrument by considering all relevant terms and features, weighting each feature based on relevant factors.

Depending on the weighting applied to each relevant term and feature (based on the facts and circumstances of the transaction), the host contract could be viewed as more akin to debt or to equity.

Factors to be considered may include, but are not limited to:
Redemption provisions
Conversion features
Nature of the returns (stated or participating)
Whether returns are mandatory or discretionary
Participation in the residual
Voting rights
Collateral requirements
Liquidation preference
Creditor rights (for example, the right to force bankruptcy)</td></tr>
</table>

		paragraph 815-10-15-74(a).	**If the host contract is determined to be more akin to debt:** Redemption Option: Per paragraphs 815-15-25-26 and 815-15-25-40 through 25-42, the embedded put option held by the investor would be considered clearly and closely related to the debt host contract. As such, bifurcation of the embedded put option would not be allowed or required by either the issuer or the investor. Conversion Option: The conversion option is an equity derivative embedded in a debt-host contract. Per paragraph 815-15-25-51, the conversion option would not be considered clearly and closely related to the debt host. The issuer and investor would need to analyze the remaining requirements in paragraphs 815-15-25-1(b) and (c) to determine whether bifurcation and fair value accounting of the conversion option is required. The issuer may be able to avoid bifurcation and fair value accounting for the conversion option if it qualifies for the scope exception provided for in paragraph 815-10-15-74(a). **If the host contract is determined to be more akin to equity:** Redemption Option: Per paragraph 815-15-25-20, a put option that enables the investor to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is not clearly and closely related to that equity instrument. As such, the issuer and investor would need to analyze the remaining requirements in paragraphs 815-15-25-1(b) and (c) to determine if bifurcation and fair value accounting of the put option is

			required. The issuer may be able to avoid bifurcation and fair value accounting for the redemption option if it qualifies for the scope exception provided for in paragraph 815-10-15-74(a). <u>Conversion Option</u>: The conversion option is an equity derivative embedded in an equity host contract. As such, the conversion option would be considered clearly and closely related to the equity host, and bifurcation would not be allowed or required by either the issuer or investor.
	View B: Chameleon Approach	It depends, but there is a rebuttable presumption that the potential downside protection provided by a non-contingent, fixed-price redemption option held by the investor would cause the economic characteristics and risks of the host contract to be more akin to debt even when the hybrid instrument includes equity-like terms and features, such as dividend participation rights, voting rights, or a conversion option. For this analysis, assume the entity concludes that the presumption cannot be overcome. <u>Conversion Option</u>: When determining whether the conversion option is clearly and closely related to the host contract, *disregarding the conversion option* in the assessment of the economic characteristics and risks of the host contract will likely lead entities to conclude that the non-contingent, fixed-price redemption option held by the investor causes the host contract to be considered more akin to debt. Under this scenario, the conversion option is an equity derivative embedded in a debt host contract. Per paragraph 815-15-25-51, the conversion option would not be considered clearly and closely related to the debt	It depends. An entity would determine the nature of the host contract of a convertible preferred equity instrument by considering all relevant terms and features (**<u>except</u>** for the embedded derivative feature being evaluated for bifurcation), weighting each feature based on relevant factors. Depending on the weighting applied to each relevant term and feature (based on the facts and circumstances of the transaction) and which embedded derivative feature is being excluded from the evaluation, the host contract could be viewed as more akin to debt or to equity. Factors to be considered may include, but are not limited to: • Redemption provisions • Conversion features • Nature of the returns (stated or participating) • Whether returns are mandatory or discretionary • Participation in the residual • Voting rights

		host. The issuer and investor would need to analyze the remaining requirements in paragraphs 815-15-25-1(b) and (c) to determine if bifurcation and fair value accounting of the conversion option is required. The issuer may be able to avoid bifurcation and fair value accounting for the conversion option if it qualifies for the scope exception provided for in paragraph 815-10-15-74(a). <u>Redemption Option</u>: When determining whether the redemption option is clearly and closely related to the host contract, *disregarding the redemption option* in the assessment of the economic characteristics and risks of the host contract will generally lead entities to conclude that the remaining features (for example, voting rights, dividend participation rights, and conversion option) cause the host contract to be more akin to equity. Per paragraph 815-15-25-20, a put option that enables the investor to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is not clearly and closely related to that equity instrument. As such, the issuer and investor would need to analyze the remaining requirements in paragraphs 815-15-25-1(b) and (c) to determine whether bifurcation and fair value accounting of the put option is required. The issuer may be able to avoid bifurcation and fair value accounting for the redemption option if it qualifies for the scope exception provided for in paragraph 815-10-15-74(a).	• Collateral requirements • Liquidation preference • Creditor rights (for example, the right to force bankruptcy) **If the host contract is determined to be more akin to debt:** <u>Redemption Option</u>: Per paragraphs 815-15-25-26 and 815-15-25-40 through 25-42, the embedded put option held by the investor would be considered clearly and closely related to the debt host contract. As such, the embedded put option would not require bifurcation by either the issuer or the investor. <u>Conversion Option</u>: The conversion option is an equity derivative embedded in a debt-host contract. Per paragraph 815-15-25-51, the conversion option would not be considered clearly and closely related to the debt host. The issuer and investor would need to analyze the remaining requirements in paragraphs 815-15-25-1(b) and (c) to determine whether bifurcation and fair value accounting of the conversion option is required. The issuer may be able to avoid bifurcation and fair value accounting for the conversion option if it qualifies for the scope exception provided for in paragraph 815-10-15-74(a). **If the host contract is determined to be more akin to equity:** <u>Redemption Option</u>: Per paragraph 815-15-25-20, a put option that enables the investor to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is not clearly and closely related to that equity instrument. As such, the issuer and

			investor would need to analyze the remaining requirements in paragraphs 815-15-25-1(b) and (c) to determine if bifurcation and fair value accounting of the put option is required. The issuer may be able to avoid bifurcation and fair value accounting for the redemption option if it qualifies for the scope exception provided for in paragraph 815-10-15-74(a). Conversion Option: The conversion option is an equity derivative embedded in an equity host contract. As such, the conversion option would be considered clearly and closely related to the equity host, and bifurcation would not be allowed or required by either the issuer or investor.

	View C: Pure-Host Approach	**View A under Issue 2 (that is, rebuttable presumption) would be N/A, as the non-contingent, fixed-price redemption option (that is, the embedded put option held by the investor) would be excluded from the assessment of the nature of the host contract under the pure-host approach.** <u>Conversion Option</u>: When determining whether the conversion option is clearly and closely related to the host contract, disregarding the embedded derivative features (that is, conversion option *and* redemption option) in the assessment of the economic characteristics and risks of the host contract will likely lead entities to conclude that the remaining features (e.g., voting rights, dividend participation rights, and perpetual maturity) cause the host contract to be more akin to equity. Under this scenario, the conversion option is an equity derivative embedded in an equity host contract. As such, the conversion option would be considered clearly and closely related to the equity host, and bifurcation would not be required by either the issuer or investor. <u>Redemption Option</u>: When determining whether the redemption option is clearly and closely related to the host contract, disregarding the embedded derivative features (that is, redemption option *and* the conversion option) in the assessment of the economic characteristics and risks of the host contract will likely lead entities to conclude that the remaining features (for example, voting rights, dividend participation rights, and perpetual maturity) cause the host contract to be more akin to equity. Per paragraph 815-15-25-20, a put option that enables the investor to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is not clearly and closely related to that equity instrument. As such, the issuer and investor would need to analyze the remaining requirements in paragraphs 815-15-25-1(b) and (c) to determine whether bifurcation and fair value accounting of the put option is required. The issuer may be able to avoid bifurcation and fair value accounting by availing itself of the scope exception provided for in paragraph 815-10-15-74(a).