AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT
FASB

SUBJECT:

FASB ISSUES ASU RELATED TO EMBEDDED DERIVATIVES IN PREFERRED STOCK

SUMMARY:

The FASB recently issued a new ASU requiring both issuers and investors to apply the "whole instrument" approach to determine whether the host contract in a hybrid instrument in the form of a share is more like debt or equity. That assessment is part of a larger analysis to determine if an embedded derivative should be bifurcated. If so, the embedded derivative, such as a conversion feature in convertible preferred stock, should be accounted for as a liability and carried at fair value through earnings each period. The ASU eliminates the "chameleon approach" to determine the nature of the host, which may have resulted in a different conclusion. The new standard takes effect in 2016 for both public and private entities and is expected to bring limited change. The standard is available here.

SCOPE, EFFECTIVE DATE AND TRANSITION:

ASU 2014-16[1] applies to issuers of and investors in hybrid financial instruments issued in the form of shares such as redeemable convertible preferred stock.

The ASU is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For all other entities, the amendments are effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016.

An entity will apply the ASU to existing hybrid financial instruments issued in the form of a share as of the beginning of the fiscal year for which the amendments

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[1] *Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity*

are effective on either a full retrospective or a modified retrospective basis. Regardless of the method of adoption, all outstanding hybrid instruments in the form of a share are subject to the new standard. In other words, there are no grandfathering provisions. Further, entities are required to determine the nature of the host instrument upon its issuance or acquisition, which may be many years in the past.

Early adoption is permitted, including adoption in an interim period. If early adoption is elected in an interim period, any transition adjustments must be reflected as of the beginning of that fiscal year.

MAIN PROVISIONS:

The whole instrument approach considers all terms and features in a hybrid financial instrument, including the embedded derivative feature that is being evaluated for separate accounting from the host contract. Specifically, the amendments require that in applying the clearly-and-closely related criterion under Subtopic 815-15 to such an instrument, an entity should determine the nature of the host contract (i.e., debt-like versus equity-like) by considering all stated and implied substantive terms and features of the hybrid financial instrument. This is known as the whole instrument approach because the terms of the embedded derivative feature being considered for separate accounting treatment are considered along with the terms of the host contract in evaluating the nature of the host contract itself. For example, when evaluating a preferred share host instrument, the related conversion option, although not necessarily determinative by itself, would be one factor indicating the preferred share is akin to equity.

The ASU requires an entity to consider the substance of the terms and features within such a hybrid instrument. In other words, an entity should weigh each term and feature on the basis of relevant facts and circumstances to determine its relative importance within the context of the overall instrument. In performing this evaluation, the entity should consider the following attributes:

1. The characteristics of the relevant terms and features themselves; for example, contingent versus noncontingent, in-the-money versus out–of-the money;
2. The circumstances under which the hybrid financial instrument was issued or acquired; for example, whether the issuer is thinly capitalized or profitable and well-capitalized; and
3. The potential outcomes of the hybrid financial instrument; for example, whether a preferred share will be converted into common stock, redeemed for cash or remain in its original form indefinitely.

The ASU provides helpful examples and extensive implementation guidance to assist entities with the evaluation of terms and features commonly included within hybrid financial instruments issued in the form of shares. These include redemption rights, conversion rights, voting rights, dividend rights, and protective covenants. No single feature is necessarily determinative. For instance, a non-contingent put feature in preferred stock does not automatically cause the host instrument to be debt-like.

The amendments do not change the criteria for when an embedded derivative feature should be bifurcated from the host contract, nor do they alter the accounting when such bifurcation is required.

BDO Comment: *While the whole-instrument approach was applied by most companies prior to the new standard, there was very little guidance in U.S. GAAP addressing debt-like vs. equity-like features embedded in a host contract in the form of a share. The final amendments include detailed implementation guidance on this point. However, some entities may find it more efficient to begin with other parts of the embedded derivative analysis. For example, a conversion feature in convertible perpetual preferred stock issued by a private company will usually lack the net settlement characteristic of a derivative. As such, bifurcation would be precluded.*