Derivatives and Hedging (Topic 815)

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

a consensus of the FASB Emerging Issues Task Force

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November 2014

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

Entities commonly raise capital by issuing different classes of shares, including preferred stock, that entitle the holders to certain preferences and rights over the other shareholders. The specific terms of those shares may include conversion rights, redemption rights, voting rights, and liquidation and dividend payment preferences, among other features. One or more of those features may meet the definition of a derivative under generally accepted accounting principles (GAAP). Shares that include such embedded derivative features are referred to as hybrid financial instruments.

An entity that issues or invests in a hybrid financial instrument is required to separate an embedded derivative feature from the host contract (for example, an underlying share) and account for the feature as a derivative according to Subtopic 815-10 on derivatives and hedging if certain criteria are met. One such criterion for separation is that the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the host contract.

In the case of derivatives embedded in a hybrid financial instrument that is issued in the form of a share, that criterion requires evaluating whether the nature of the host contract is more akin to debt or to equity and whether the economic characteristics and risks of the embedded derivative feature are clearly and closely related to the host contract. 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 separated from the host contract. If the host contract is akin to debt, then equity-like features are not considered clearly and closely related to the host contract. In the latter case, an entity may be required to separate the equity-like embedded derivative feature from the debt host contract if certain other criteria in Subtopic 815-15 are met. Similarly, debt-like embedded derivative features may require separate accounting from an equity-like host contract.

There are predominantly two methods used in current practice by issuers and investors in evaluating whether the nature of the host contract within a hybrid financial instrument issued in the form of a share is more akin to debt or to equity. One of the methods considers all terms and features in a hybrid financial instrument including the embedded derivative feature that is being evaluated for separate accounting. The other method considers all terms and features in the hybrid financial instrument except the embedded derivative feature that is being evaluated for separate accounting. The use of different methods can result in
different accounting outcomes for economically similar hybrid financial instruments.

Additionally, there is diversity in practice with respect to the consideration of redemption features in relation to other features when determining whether the nature of a host contract is more akin to debt or to equity.

The objective of this Update is to eliminate the use of different methods in practice and thereby reduce existing diversity under GAAP in the accounting for hybrid financial instruments issued in the form of a share.

Who Is Affected by the Amendments in This Update?

The amendments in this Update apply to all entities that are issuers of, or investors in, hybrid financial instruments that are issued in the form of a share.

What Are the Main Provisions?

For hybrid financial instruments issued in the form of a share, an entity (an issuer or an investor) should determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature on the basis of relevant facts and circumstances. That is, an entity should determine the nature of the host contract by considering the economic characteristics and risks of the entire hybrid financial instrument, including the embedded derivative feature that is being evaluated for separate accounting from the host contract.

In evaluating the stated and implied substantive terms and features, the existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. Although an individual term or feature may weigh more heavily in the evaluation on the basis of facts and circumstances, an entity should use judgment based on an evaluation of all the relevant terms and features. For example, the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract is not, in and of itself, determinative in the evaluation of whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument. Rather, the nature of the host contract depends on the economic characteristics and risks of the entire hybrid financial instrument.
How Do the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The amendments in this Update do not change the current criteria in GAAP for determining when separation of certain embedded derivative features in a hybrid financial instrument is required. That is, an entity will continue to evaluate whether the economic characteristics and risks of the embedded derivative feature are clearly and closely related to those of the host contract, among other relevant criteria. The amendments clarify how current GAAP should be interpreted in evaluating the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a share. Specifically, the amendments clarify that an entity should consider all relevant terms and features—including the embedded derivative feature being evaluated for bifurcation—in evaluating the nature of the host contract. Furthermore, the amendments clarify that no single term or feature would necessarily determine the economic characteristics and risks of the host contract. Rather, the nature of the host contract depends upon the economic characteristics and risks of the entire hybrid financial instrument.

In addition, the amendments in this Update clarify that, in evaluating the nature of a host contract, an entity should assess the substance of the relevant terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weight those terms and features. Specifically, the assessment of the substance of the relevant terms and features should incorporate a consideration of (1) the characteristics of the 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, issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized), and (3) the potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes.

When Will the Amendments Be Effective?

The effects of initially adopting the amendments in this Update should be applied on a modified retrospective basis to existing hybrid financial instruments issued in the form of a share as of the beginning of the fiscal year for which the amendments are effective. Retrospective application is permitted to all relevant prior periods.
The amendments in this Update are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. Early adoption, including adoption in an interim period, is permitted. If an entity early adopts the amendments in an interim period, any adjustments shall be reflected as of the beginning of the fiscal year that includes that interim period.

How Do the Provisions Compare with International Financial Reporting Standards (IFRS)?

Similar to the guidance in Topic 815, the guidance in IAS 39, Financial Instruments: Recognition and Measurement, states that one criterion for an embedded derivative feature to be separated from a host contract and accounted for as a derivative is that the economic characteristics and risks of the embedded derivative feature are not closely related to the economic characteristics and risks of the host contract. In addition, IAS 39 does not provide determinative guidance on the appropriate method to be applied in determining whether the nature of the host contract within a hybrid financial instrument issued in the form of a share is more akin to debt or to equity for the purposes of the embedded derivative analysis.

In July 2014, the IASB published a revised version of IFRS 9, Financial Instruments, which is effective for annual periods beginning on or after January 1, 2018 (early application is permitted). IFRS 9 carries forward a number of the provisions of IAS 39 with respect to financial liabilities, including the guidance requiring the separation of certain embedded derivative features from the host contract. However, one of the provisions in IFRS 9 eliminates the requirement to separate embedded derivative features from financial assets. While embedded derivative features would no longer require separation from financial assets under IFRS 9, those features could affect the classification and, therefore, the measurement of the entire financial asset. Specifically, IFRS 9 requires financial assets to be classified on the basis of the business model within which they are held and their contractual cash flow characteristics.
Amendments to the  
**FASB Accounting Standards Codification**®

**Introduction**

1. The Accounting Standards Codification is amended as described in paragraphs 2–4. In some cases, to put the change into context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is struck out.

**Amendments to Subtopic 815-15**

2. Amend paragraphs 815-15-25-16 through 25-17 and 815-15-25-20 and add paragraphs 815-15-25-17A through 25-17D, with a link to transition paragraph 815-15-65-2, as follows:

**Derivatives and Hedging—Embedded Derivatives**

**Recognition**

> **Applying the Clearly-and-Closely Related Criterion**

**815-15-25-16** 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.

**815-15-25-17** 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.
815-15-25-17A For a hybrid financial instrument issued in the form of a share, an entity shall determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature on the basis of the relevant facts and circumstances. That is, in determining the nature of the host contract, an entity shall consider the economic characteristics and risks of the entire hybrid financial instrument including the embedded derivative feature that is being evaluated for potential bifurcation. In evaluating the stated and implied substantive terms and features, the existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. Although an individual term or feature may weigh more heavily in the evaluation on the basis of the facts and circumstances, an entity should use judgment based on an evaluation of all of the relevant terms and features. For example, an entity shall not presume that the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract, in and of itself, determines whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument. Rather, the nature of the host contract depends on the economic characteristics and risks of the entire hybrid financial instrument.

815-15-25-17B The guidance in paragraph 815-15-25-17A relates to determining whether a host contract within a hybrid financial instrument issued in the form of a share is considered to be more akin to a debt instrument or more akin to an equity instrument for the purposes of evaluating one or more embedded derivative features for bifurcation under paragraph 815-15-25-1(a). It is not intended to address when an embedded derivative feature should be bifurcated from the host contract or the accounting when such bifurcation is required. In addition, the guidance in paragraph 815-15-25-17A is not intended to prescribe the method to be used in determining the nature of the host contract in a hybrid financial instrument that is not issued in the form of a share.

815-15-25-17C When applying the guidance in paragraph 815-15-25-17A, an entity shall determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, determining whether those terms and features are debt-like versus equity-like, and weighing those terms and features on the basis of the relevant facts and circumstances. That is, an entity shall consider not only whether the relevant terms and features are debt-like versus equity-like, but also the substance of those terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances). In assessing the substance of the relevant terms and features, each of the following may form part of the overall analysis and may inform an entity’s overall consideration of the relative importance (and, therefore, weight) of each term and feature among other terms and features:
a. The characteristics of the relevant terms and features themselves (for example, contingent versus noncontingent, in-the-money versus out-of-the-money)

b. The circumstances under which the hybrid financial instrument was issued or acquired (for example, issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized)

c. The potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes. The assessment of the potential outcomes may be qualitative in nature.

815-15-25-17D The following are examples (and not an exhaustive list) of common terms and features included within a hybrid financial instrument issued in the form of a share and the types of information and indicators that an entity (an issuer or an investor) may consider when assessing the substance of those terms and features in the context of determining the nature of the host contract, as discussed in paragraph 815-15-25-17C:

a. Redemption rights. The ability for an issuer or investor to redeem a hybrid financial instrument issued in the form of a share at a fixed or determinable price generally is viewed as a debt-like characteristic. However, not all redemption rights are of equal importance. For example, a noncontingent redemption option may be given more weight in the analysis than a contingent redemption option. The relative importance (and, therefore, weight) of redemption rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether the redemption right is held by the issuer or investors
2. Whether the redemption is mandatory
3. Whether the redemption right is noncontingent or contingent
4. Whether (and the degree to which) the redemption right is in-the-money or out-of-the-money
5. Whether there are any laws that would restrict the issuer or investors from exercising the redemption right (for example, if redemption would make the issuer insolvent)
6. Issuer-specific considerations (for example, whether the hybrid financial instrument is effectively the residual interest in the issuer [due to the issuer being thinly capitalized or the common equity of the issuer having already incurred losses] or whether the instrument was issued by a well-capitalized, profitable entity)
7. If the hybrid financial instrument also contains a conversion right, the extent to which the redemption price (formula) is more or less favorable than the conversion price (formula), that is,
consideration of the economics of the redemption price (formula) and the conversion price (formula), not simply the form of the settlement upon redemption or conversion.

b. Conversion rights. The ability for an investor to convert, for example, a preferred share into a fixed number of common shares generally is viewed as an equity-like characteristic. However, not all conversion rights are of equal importance. For example, a conversion option that is noncontingent or deeply in-the-money may be given more weight in the analysis than a conversion option that is contingent on a remote event or deeply out-of-the-money. The relative importance (and, therefore, weight) of conversion rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:
   1. Whether the conversion right is held by the issuer or investors
   2. Whether the conversion is mandatory
   3. Whether the conversion right is noncontingent or contingent
   4. Whether (and the degree to which) the conversion right is in-the-money or out-of-the-money
   5. If the hybrid financial instrument also contains a redemption right held by the investors, whether conversion is more likely to occur before redemption (for example, because of an expected initial public offering or change-in-control event before the redemption right becoming exercisable).

c. Voting rights. The ability for a class of stock to exercise voting rights generally is viewed as an equity-like characteristic. However, not all voting rights are of equal importance. For example, voting rights that allow a class of stock to vote on all significant matters may be given more weight in the analysis than voting rights that are only protective in nature. The relative importance (and, therefore, weight) of voting rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:
   1. On which matters the voting rights allow the investor’s class of stock to vote (relative to common stock shareholders)
   2. How much influence the investor’s class of stock can exercise as a result of the voting rights.

d. Dividend rights. The nature of dividends can be viewed as a debt-like or equity-like characteristic. For example, mandatory fixed dividends generally are viewed as a debt-like characteristic, while discretionary dividends based on earnings generally are viewed as an equity-like characteristic. The relative importance (and, therefore, weight) of dividend terms among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:
   1. Whether the dividends are mandatory or discretionary
2. The basis on which dividends are determined and whether the dividends are stated or participating
3. Whether the dividends are cumulative or noncumulative.

e. Protective covenants. Protective covenants generally are viewed as a debt-like characteristic. However, not all protective covenants are of equal importance. Covenants that provide substantive protective rights may be given more weight than covenants that provide only limited protective rights. The relative importance (and, therefore, weight) of protective covenants among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether there are any collateral requirements akin to collateralized debt
2. If the hybrid financial instrument contains a redemption option held by the investor, whether the issuer’s performance upon redemption is guaranteed by the parent of the issuer
3. Whether the instrument provides the investor with certain rights akin to creditor rights (for example, the right to force bankruptcy or a preference in liquidation).

> > Host Contracts with Equity Characteristics

815-15-25-20 A put option that enables the holder to require the issuer of an equity instrument (which has been deemed to contain an equity host contract in accordance with paragraphs 815-15-25-17A through 25-17D) to reacquire that equity instrument for cash or other assets is not clearly and closely related to that equity instrument. Thus, such a put option embedded in a publicly traded equity instrument to which it relates shall be separated from the host contract by the holder of the equity instrument if the criteria in paragraph 815-15-25-1(b) through (c) are also met. That put option also shall be separated from the host contract by the issuer of the equity instrument except in those circumstances in which the put option is not considered to be a derivative instrument pursuant to paragraph 815-10-15-74(a) because it is classified in stockholders’ equity. A purchased call option that enables the issuer of an equity instrument (such as common stock) to reacquire that equity instrument would not be considered to be a derivative instrument by the issuer of the equity instrument pursuant to that paragraph. Thus, if the call option were embedded in the related equity instrument, it would not be separated from the host contract by the issuer. However, for the holder of the related equity instrument, the embedded written call option would not be considered to be clearly and closely related to the equity instrument, if the criteria in paragraph 815-15-25-1(b) through (c) were met, and shall be separated from the host contract.

3. Add paragraph 815-15-65-2 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 2014-16, Derivatives and Hedging (Topic 815): 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

815-15-65-2 The following represents the transition and effective date information related to Accounting Standards Update No. 2014-16, Derivatives and Hedging (Topic 815): 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:

a. For public business entities, the pending content that links to this paragraph shall be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.

b. At the effective date of the pending content that links to this paragraph, an entity shall assess each existing hybrid financial instrument issued in the form of a share to determine whether any of those hybrid financial instruments contain one or more embedded derivative features that, according to the guidance in the pending content that links to this paragraph, may require either of the following adjustments:
   1. Bifurcation of the embedded derivative feature
   2. A previously bifurcated embedded derivative feature to no longer be bifurcated.

   In performing this assessment, an entity shall consider the economic characteristics and risks of the hybrid financial instrument and the embedded derivative feature(s) being evaluated as they existed at the date of initial recognition of the instrument (that is, upon issuance or acquisition).

c. The effects of initially complying with the pending content that links to this paragraph as of the effective date shall be reported as a cumulative-effect adjustment directly to retained earnings as of the beginning of the year of adoption.

d. If an entity had not bifurcated an embedded derivative feature but is required to do so as a result of applying the pending content that links to this paragraph, the carrying amount of the host contract at the effective date of the pending content that links to this paragraph shall be based on a pro forma bifurcation as of the date the entity issued or acquired the hybrid financial instrument (that is, assume the embedded derivative feature had been bifurcated as of the date the entity issued or acquired the hybrid financial instrument) and the host contract's subsequent accounting before the effective date. At the effective date of the pending content that links to this paragraph, the transition adjustment shall be the difference between the total carrying amount of the individual components of the newly bifurcated hybrid financial instrument and the
carrying amount of the combined hybrid financial instrument before bifurcation.

e. If an entity had bifurcated an embedded derivative feature but is no longer required to do so as a result of applying the pending content that links to this paragraph, the carrying amount of the related hybrid financial instrument at the effective date of the pending content that links to this paragraph shall be the total carrying amount of the host contract and the fair value of the previously bifurcated embedded derivative feature. No cumulative-effect adjustment to beginning retained earnings for the period of adoption is warranted.

f. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted. If an entity early adopts the pending content that links to this paragraph in an interim period, any adjustments (see paragraphs 815-15-65-2(b) through (d)) shall be reflected as of the beginning of the fiscal year that includes that interim period.

g. Retrospective application is permitted but not required.

h. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-2 (with the exception of the disclosure in paragraph 250-10-50-1(b)(2)) in the period the entity adopts the pending content that links to this paragraph.

4. Amend paragraph 815-15-00-1, by adding the following items to the table, as follows:

**815-15-00-1** The following table identifies the changes made to this Subtopic.

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Action</th>
<th>Accounting Standards Update</th>
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<tr>
<td><strong>Public Business Entity</strong></td>
<td>Added</td>
<td>2014-16</td>
<td>11/03/2014</td>
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<td>815-15-25-17</td>
<td>Amended</td>
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<td>11/03/2014</td>
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<tr>
<td>815-15-25-17A through 25-17D</td>
<td>Added</td>
<td>2014-16</td>
<td>11/03/2014</td>
</tr>
</tbody>
</table>
The amendments in this Update were adopted by the affirmative vote of six members of the Financial Accounting Standards Board. Mr. Linsmeier dissented.

Mr. Linsmeier dissents from the issuance of this Accounting Standards Update for three primary reasons. First, he believes that the “whole-instrument” method prescribed in this Accounting Standards Update for evaluating whether an embedded derivative should be separated from a hybrid financial instrument and accounted for as a derivative instrument is inconsistent with Topic 815 because it requires that the embedded derivative feature(s) in a hybrid financial instrument be considered as being part of the host contract. Mr. Linsmeier notes that the Master Glossary of the Codification defines a hybrid instrument as “a contract that embodies both an embedded derivative and a host contract.” In addition, paragraph 815-15-25-1 states (in part) that “an embedded derivative shall be separated from the host contract . . . [when] 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.” Mr. Linsmeier also references paragraph 815-15-25-16, which states, “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.” He believes that the cited guidance makes it clear that in Topic 815 embedded derivative feature(s) in a hybrid financial instrument are considered to be separate from and not part of the host contract, which is inconsistent with the method and analysis required by this Accounting Standards Update.

Second, Mr. Linsmeier believes that the method prescribed in this Accounting Standards Update increases the likelihood that an embedded derivative feature will be found to be clearly and closely related to itself, which he believes is conceptually flawed. For example, under the method in this Accounting Standards Update, an entity may conclude that the host contract within aredeemable preferred equity instrument is akin to debt primarily because the hybrid financial instrument contains an embedded redemption option to settle the instrument in a fixed or determinable amount of cash. In that situation, the debt-like embedded redemption option would by construction be considered clearly and closely related to the debt-like host contract (and therefore, not subject to bifurcation) because the analysis would require a comparison of the economic characteristics and risks of the redemption option to itself. Mr. Linsmeier does not believe that this method achieves the objective of the clearly-and-closely-related analysis in Topic 815 and, in some circumstances, will result in too infrequent separation of embedded derivative features from the host contract.

Third, Mr. Linsmeier believes that by limiting the scope of this Accounting Standards Update to hybrid financial instruments that are issued in the form of a share, the economic characteristics and risks of a host contract may be determined differently for hybrid financial instruments that are not issued in the
form of a share. This difference adds a layer of complexity to an area of the accounting guidance that already is extremely complex.

Mr. Linsmeier would have preferred that this Accounting Standards Update require the use of a “clean-host” approach that disregards all embedded derivative features when determining the economic characteristics and risks of the host contract. He believes that this approach is the only method that is consistent with Topic 815. Such an approach would rely more on the legal form of the instrument in determining the economic characteristics and risks of the host contract, making it consistent with many other aspects of Topic 815. Mr. Linsmeier also would have preferred that the scope of this Accounting Standards Update would have included all hybrid financial instruments, not just those issued in the form of a share.

*Members of the Financial Accounting Standards Board:*

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Daryl E. Buck
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith
Background Information and Basis for Conclusions

BC1. The following summarizes the Task Force’s considerations in reaching the conclusions in this Update. It includes the Board’s basis for ratifying the Task Force conclusions when needed to supplement the Task Force’s considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual Task Force and Board members gave greater weight to some factors than to others.

Background Information

BC2. Entities commonly raise capital by issuing different classes of shares, including preferred stock, that entitle the holders to certain preferences and rights over the other shareholders. The specific terms of those shares may include conversion rights, redemption rights, voting rights, and liquidation and dividend payment preferences, among other features. One or more of those features may meet the definition of a derivative under GAAP. Shares that include such embedded derivative features are referred to as hybrid financial instruments.

BC3. An entity that issues or invests in a hybrid financial instrument issued in the form of a share is required to separate an embedded derivative feature from the host contract (for example, an underlying share) and account for the feature as a derivative according to Subtopic 815-10 if certain criteria are met. One of those criteria is that the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the host contract.

BC4. In the case of derivatives embedded in a hybrid financial instrument that is issued in the form of a share, that criterion requires evaluating whether the nature of the host contract is more akin to debt or to equity and whether the economic characteristics and risks of the embedded derivative feature are clearly and closely related to the host contract. 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 separated from the host contract. If the host contract is akin to debt, then equity-like features are not considered clearly and closely related to the host contract. In the latter case, an entity may be required to separate the equity-like embedded derivative feature from the debt host contract if certain other criteria in Subtopic 815-15 are met. Similarly, debt-like embedded derivative features may require separate accounting from an equity-like host contract.
BC5. There are predominantly two methods used in current practice by issuers and investors in evaluating whether the nature of the host contract within a hybrid financial instrument issued in the form of a share is more akin to debt or to equity. One of the methods considers all terms and features in a hybrid financial instrument including the embedded derivative feature that is being evaluated for separate accounting. The other method considers all terms and features in the hybrid financial instrument except for the embedded derivative feature that is being evaluated for separate accounting. The use of different methods can result in different accounting outcomes for economically similar hybrid financial instruments. Additionally, there is diversity in practice with respect to the consideration of redemption features in relation to other features when determining whether the nature of a host contract is more akin to debt or to equity. For example, some consider the existence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock to be determinative in concluding that the host contract is akin to debt. Others believe that the existence of that redemption option would not, in and of itself, determine whether the host contract is akin to debt or to equity. The objective of this Update is to eliminate the use of different methods in practice and thereby reduce existing diversity under GAAP in the accounting for hybrid financial instruments issued in the form of a share.

BC6. The Board previously issued a proposed Accounting Standards Update, Derivatives and Hedging (Topic 815): 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, on October 23, 2013, with a comment period that ended on December 23, 2013. The Board received nine comment letters.

Scope

BC7. The Task Force reached a consensus that the amendments in this Update should apply to all entities that are issuers of, or investors in, hybrid financial instruments that are issued in the form of a share. The Task Force decided that limiting the scope to hybrid financial instruments issued in the form of a share is appropriate on the basis of feedback indicating that diversity in practice is observed most commonly in the treatment of hybrid financial instruments issued in the form of a share (for example, convertible preferred stock).

Method for Evaluating the Nature of the Host Contract

BC8. For a hybrid financial instrument issued in the form of a share, the Task Force reached a consensus that an entity should determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature on the basis of relevant facts and circumstances. That is, an entity should determine the
nature of the host contract by considering the economic characteristics and risks of the entire hybrid financial instrument, including the embedded derivative feature that is being evaluated for separate accounting from the host contract.

BC9. In supporting that decision, the Task Force noted that it is not appropriate to disregard any term or feature when analyzing the economic characteristics and risks of the host contract because the instrument’s cash flows ultimately depend on the interaction of all contractual provisions within the instrument and the way in which an investor or issuer may exercise options within the contract.

BC10. The Task Force also noted that this approach is the most commonly used approach in current practice.

BC11. The Task Force acknowledged that this approach could result in situations in which an embedded derivative feature is, in effect, found to be clearly and closely related to itself. However, the Task Force decided that the alternative approach (of considering all terms and features except the embedded derivative feature that is being evaluated for separate accounting) would have been less desirable, because it would have required a separate determination of the nature of the host contract for each embedded derivative feature being evaluated for separate accounting and it would have had the potential to result in (a) the host contract changing its nature depending on the embedded derivative feature being evaluated and/or (b) separating a compound derivative that includes both equity-like and debt-like features, which may be difficult for preparers to value and investors to understand. The Task Force concluded that it is not appropriate for a host contract within a single hybrid financial instrument to change its nature for the purposes of this evaluation when the economics of the instrument remain unchanged.

BC12. The Task Force also considered but rejected an alternative that would have disregarded all embedded derivative features when analyzing the economic characteristics and risks of the host contract. The Task Force rejected that approach because it could have resulted in an over-reliance on the legal form of the instrument in determining the nature of the host, as opposed to consideration of all relevant terms, features, facts, and circumstances.

Consideration of Redemption Features

BC13. In evaluating all relevant stated and implied substantive terms and features of a hybrid financial instrument issued in the form of a share, the Task Force noted that there is diversity in practice with respect to how entities are considering a fixed-price, noncontingent redemption option held by the investor when determining the nature of the host contract. The Task Force decided that in evaluating the terms and features of a hybrid financial instrument issued in the form of a share, the existence or omission of any single term or feature, including a fixed-price, noncontingent redemption feature held by the investor, should not necessarily determine the economic characteristics and risks of the host contract.
Although an individual term or feature may weigh more heavily in the evaluation on the basis of facts and circumstances, an entity should use judgment based on an evaluation of all of the relevant terms and features.

BC14. The Task Force decided that an entity should consider the specific facts and circumstances about the transaction and not presume that a single feature, such as a fixed-price, noncontingent redemption option held by the investor, would determine that the host contract is more akin to debt or more akin to equity. The Task Force considered but rejected providing more determinative guidance, such as a rebuttable presumption that the existence of a fixed-price, noncontingent redemption option held by the investor would determine that a host contract is akin to debt (as a result of the potential downside protection that such a feature provides for the holder). In rejecting that approach, the Task Force noted that it is not possible to reasonably establish that as a likely economic outcome. For example, if an issuer does not have sufficient capital, the issuer would be unable to redeem the instrument even if the investor exercised the redemption option. That would be the case under various state laws and corporate charters under which a preferred share cannot be redeemed if it would cause the issuer to become insolvent. Accordingly, even with a redemption option, an investor may be exposed to the residual risks (that is, negative movements) of an equity investment.

BC15. The Task Force also observed that for private issuers of preferred shares, in many cases, either the issuer would perform well and have a liquidity event (in which case the conversion option would be exercised) or the issuer would perform poorly (in which case the preferred shareholders would effectively become the residual interest holders). Therefore, the Task Force noted that, in many circumstances, the redemption option would not be exercised.

Implementation Guidance

BC16. On the basis of feedback received during the comment letter process, the Task Force decided to provide implementation guidance to be used by entities to weigh particular terms and features relative to other terms and features. The Task Force decided that when determining the nature of a host contract, an entity should identify the relevant terms and features, stated and implied, within the hybrid financial instrument that will be analyzed to determine the nature of the host contract (for example, conversion option, redemption option, voting rights, dividend rights, and protective covenants) and determine whether those terms and features are, by their nature, debt-like or equity-like.

BC17. In addition, the Task Force decided that an entity should assess the substance of the relevant terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weigh those terms and features. That is, the Task Force concluded that it is important to determine not only which terms and
features are debt-like versus equity-like in the context of the host contract analysis, but also the extent to which those terms and features are debt-like or equity-like. Specifically, the assessment of the substance of the relevant terms and features should incorporate a consideration of (a) the characteristics of the terms and features themselves (for example, contingent versus noncontingent, in-the-money versus out-of-the-money), (b) the circumstances under which the hybrid financial instrument was issued or acquired (for example, issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized), and (c) the potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes. The Task Force also decided that the assessment of the potential outcomes may be qualitative in nature. The Task Force concluded that this incremental guidance will help articulate when certain terms and features should carry more or less weight when analyzing the nature of the host contract and, therefore, reduce the diversity in practice by providing a framework for evaluating the nature of the host contract.

Transition

BC18. The Task Force reached a consensus that the effects of initially adopting the amendments in this Update should be applied on a modified retrospective basis to existing hybrid financial instruments issued in the form of a share as of the beginning of the fiscal year for which the amendments are effective. This transition method is consistent with other clarifying guidance issued by the Board on accounting for embedded derivative features, as well as the transition framework established by the Derivatives Implementation Group in Statement 133 Implementation Issue K5, “Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues.” Retrospective application is permitted to all relevant prior periods. The Task Force decided that, upon adoption, an entity should consider the economic characteristics and risks of the hybrid financial instrument and the embedded derivative feature being evaluated as they existed at the date of initial recognition of the instrument (that is, upon issuance or acquisition).

BC19. The Task Force considered allowing a prospective transition alternative for entities other than public business entities but rejected that notion because of the availability of the modified retrospective alternative—which the Task Force concluded is a practical transition method for all entities—and the fact that many hybrid financial instruments issued in the form of a share are long-term in nature, meaning a prospective transition alternative could have promoted inconsistency and a lack of comparability for a significant period of time.
Effective Date

BC20. The Task Force reached a consensus that the amendments in this Update should be effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the Task Force reached a consensus that the amendments in this Update should be effective for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. Early adoption, including adoption in an interim period, is permitted.

BC21. The Task Force considered allowing a one-year delay of the effective date for entities other than public business entities but rejected this notion given the length of time until the effective date, availability of the modified retrospective transition alternative, general consistency between the amendments and current practice, and the fact that entities other than public business entities do not have to adopt the amendments during interim periods within the initial year of adoption.

Benefits and Costs

BC22. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Task Force’s assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC23. The Task Force does not anticipate that the amendments in this Update will introduce significant incremental costs for many entities because the amendments are intended to clarify GAAP, not set new GAAP. However, the Task Force acknowledges that some entities that may have applied a different method than the method in this Update may incur incremental costs at the time of initial adoption of the amendments. The Task Force expects that those incremental costs will not recur in subsequent reporting periods. The Task Force concluded that those costs are justified because by clarifying existing guidance, consistent application of GAAP is improved and, thereby, diversity is reduced.
Amendments to the XBRL Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update require changes to the U.S. GAAP Financial Reporting Taxonomy (UGT). Those changes, which will be incorporated into the proposed 2015 UGT, are available for public comment through ASU Taxonomy Changes provided at www.fasb.org, and finalized as part of the annual release process starting in September 2014.