Hybrid preferred stock instruments
New guidance requires reassessment

At a glance

A new FASB Accounting Standards Update (ASU) will impact whether a derivative embedded in preferred stock must be bifurcated and accounted for separately from its host contract. When determining the nature of the host contract, the ASU requires reporting entities to consider all relevant terms and features, including the feature being evaluated for bifurcation and separate accounting. The ASU clarifies that no single term or feature will necessarily determine the nature of the host contract.

The ASU is effective for fiscal years beginning after December 15, 2015 and requires all existing hybrid instruments issued in the form of a share to be reassessed upon adoption. Early adoption is permitted.

Background

.1 In November 2014, the FASB issued Accounting Standards Update No. 2014-16, Derivatives and Hedging – 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 (the “ASU” or “ASU 2014-16”). The ASU, which emanated from an Emerging Issues Task Force issue, addresses diversity in practice related to the determination of whether derivative features embedded in hybrid instruments issued in the form of a share should be bifurcated and accounted for separately. The need to consider bifurcation occurs often in accounting for preferred stock financings that have embedded derivative features, such as redemption or conversion options (“hybrid preferred equity instruments”).

.2 Existing embedded derivative guidance (ASC 815-15-25-1), which applies to both issuers of and investors in hybrid preferred equity instruments, requires a reporting entity to bifurcate and account for a feature embedded in a hybrid instrument as a derivative at fair value if each of the following three criteria are met:

a) The economic characteristics of the embedded feature are not clearly and closely related to the economic characteristics and risks of the host contract.

b) The hybrid instrument is not remeasured at fair value through earnings under other generally accepted accounting principles (“GAAP”).

c) If issued as a freestanding instrument, the embedded feature would meet the definition of a derivative and would not otherwise qualify for a scope exception from the derivative rules.
Determining whether an embedded feature is clearly and closely related to a hybrid preferred equity instrument can be complex, particularly when the instrument contains both debt-like and equity-like terms and features. The existence of both debt-like and equity-like features in the instrument can introduce judgment into the host contract determination. In addition, the conclusions reached by issuers and investors when analyzing the same hybrid preferred equity instruments can differ due to the availability of scope exceptions and the point in the instrument’s life cycle at which the analysis is performed. The highly judgmental nature of the host contract determination resulted in diversity in practice in which similar hybrid preferred equity instruments were considered to contain a debt host contract by some reporting entities and an equity host contract by others.

If the host contract is determined to be more akin to equity, then any equity-like embedded features (e.g., conversion features) are generally considered clearly and closely related to the host contract and separate accounting would not be required. However, any debt-like embedded features would not be considered clearly and closely related, and those features may need to be bifurcated and accounted for separately. The conclusion would depend on whether the other two criteria described above are met, including whether or not the embedded feature qualifies for a scope exclusion.

Alternatively, if the host contract is determined to be more akin to debt, then any equity-like embedded features would not be considered clearly and closely related to the host contract. If a host contract is determined to be more akin to a debt host contract, bifurcation and separate accounting for the embedded equity-like feature may be required. Again, the conclusion would depend on whether the other two criteria described above are met.

A host contract is more debt-like when the holder’s economic exposure is more characteristic of a lender in a borrowing. For example, a debt instrument holder would have downside protection and would be principally expected to earn a fixed or interest rate indexed return. A host contract is more equity-like when the holder is exposed to economic characteristics to which a holder of an entity’s residual interest (i.e., common stockholders) would customarily be exposed. For example, a residual interest holder would have greater exposure to both positive and negative changes in the entity’s net assets. It is the presence of both lender and residual interest holder returns/exposures in hybrid preferred equity instruments that makes determining the host contract very challenging.

Historically, two approaches have been applied when determining the nature of the host contract in a hybrid preferred equity instrument: the “chameleon” approach and the “whole-instrument” approach. Application of the chameleon approach requires a reporting entity to evaluate the economic characteristics of each embedded feature relative to the host contract to determine whether that feature is clearly and closely related. The determination of the nature of the host contract is based on an analysis of all substantive terms and features of the hybrid instrument except the feature being analyzed. This means that if a hybrid instrument contains multiple embedded features, the nature of the host contract would be assessed considering each embedded feature separately. Consequently, the nature of the host contract may change depending on the feature being analyzed—thus, the “chameleon” designation.

The whole-instrument approach requires consideration of all stated or implied terms or features, including the feature being analyzed, when determining the nature of the host contract. Once that determination has been made, the economic characteristics of each embedded feature are separately compared to the economic characteristics of the host contract to determine whether the embedded feature is clearly and closely related to the host contract. Given that all features are considered when analyzing the nature of the host contract, determining the relative weighting of the individual features, or whether
some features are more important than others, is a critical aspect of the whole instrument approach.

.9 During its redeliberations of the ASU, the Emerging Issues Task Force (the Task Force) observed that some reporting entities believed that the existence of a fixed-price, investor-controlled redemption feature is determinative that the host contract is more akin to debt. This view is based on the downside protection the holder of the instrument is provided (i.e., the holder is exposed to positive changes in the entity’s net assets only and is much less exposed to the issuer’s residual risks). This conclusion was reached notwithstanding equity-like features, such as a conversion feature, voting rights, and the right to participate in dividends with the common stockholders on an “as-converted” basis. As a result, proponents of this view (both issuers and investors alike) may have bifurcated and separately accounted for embedded conversion features in such instances.

.10 The Task Force observed that in other cases, reporting entities concluded that the fixed-price, investor-controlled redemption feature was not determinative because other equity-like features could outweigh the redemption option. Proponents of this view argued that the existence of a fixed-price, investor controlled redemption feature did not indicate that the host contract was more akin to debt if the redemption feature had less relative substance. Additionally, the host contract may have contained other equity-like embedded features that, when considered in aggregate, indicated that the economics provided to the holder of the instrument were principally an equity-based return.

**Key provisions**

**Scope**

.11 The ASU applies to both issuers of and investors in hybrid financial instruments issued in the form of a share containing embedded features. The transition provisions of the ASU require a reporting entity to reassess all existing hybrid host instruments issued in the form of a share upon adoption of the ASU.

**Evaluating the nature of the host contract**

.12 ASU 2014-16 requires application of the whole-instrument approach when determining whether the host contract in a hybrid preferred equity instrument is more akin to a debt or equity. Accordingly, all stated or implied features must be considered. Each term or feature should be weighted based on the relevant facts and circumstances. The Task Force determined that it is inappropriate to disregard any substantive term or feature embedded in a hybrid preferred equity instrument because the instrument’s ultimate cash flows are dependent on the interaction of all of the instrument’s terms and features.

.13 Additionally, the circumstances surrounding the issuance or acquisition of hybrid preferred equity instruments should be considered when determining the nature of the host contract, as well as the likelihood that an issuer or investor is expected to exercise any options within the host contract.

**PwC observation:**

The Task Force’s decision to mandate the use of the whole-instrument approach was guided by its desire for a model that is more easily understandable for both issuers and investors. The chameleon approach was rejected because it requires a host contract to be reassessed each time an embedded feature is analyzed, which makes application of the model more complex. The Task Force also cited concerns with the potential changing nature of a host contract using the chameleon approach when an instrument’s total economics remained unchanged.
Consideration of fixed-price, non-contingent redemption features

.14 Application of the whole-instrument approach when determining the nature of a convertible preferred equity instrument containing a non-contingent, fixed-price redemption feature may previously have resulted in different conclusions by reporting entities. To narrow diversity in practice, the Task Force considered but ultimately rejected a rebuttable presumption that a fixed-price redemption feature that is currently exercisable by an investor (or becomes exercisable solely due to the passage of time) is determinative that the host contract is akin to debt.

.15 The Task Force chose not to establish a rebuttable presumption in part because an investor in a convertible preferred equity instrument containing a fixed-price redemption feature may nonetheless be exposed to the residual risks of the issuer. This could be a significant exposure in instances where the issuer is thinly capitalized and lacks sufficient liquid assets to settle the instrument upon redemption. Certain legal jurisdictions may prevent the issuer from settling the instrument upon the investor’s exercise of the redemption feature if doing so would cause the issuer to become insolvent. In such cases, the investor is exposed to the issuer’s residual interest without substantive downside protection.

.16 For example, some entities that issue hybrid preferred equity instruments may be thinly capitalized and may not be highly profitable. In these circumstances, investors may invest with an expectation that the entity will become highly profitable in the future and allow the investor to exit these instruments by converting them into common stock of the issuer, thereby exposing the investor to the entity’s residual “upside.” Alternatively, if the issuer fails to meet expectations and is eventually liquidated, the investors may effectively have a residual interest in the entity despite the existence of the redemption feature. In circumstances where these two outcomes are the most likely, the support for concluding that there is an equity host contract may be compelling, notwithstanding the presence of the fixed-price redemption feature.

.17 In addition, although not as frequent, there may be circumstances where a highly creditworthy entity issues a hybrid preferred equity instrument. In those circumstances it is likely that a non-contingent redemption feature will be considered substantive because if exercised, the company would be able to satisfy its redemption obligation. That notwithstanding, the terms of the instrument may contain equity features that in aggregate provide the holder with an overall equity-like return. For example, a hybrid preferred equity instrument may be issued with voting rights, a substantive participating dividend, and a conversion option that is highly likely to be exercised before the redemption feature becomes exercisable. In these circumstances, it may be reasonable to conclude that the host is more equity-like.

.18 In contrast, a hybrid preferred equity instrument issued by a highly creditworthy entity with substantive debt-like features (i.e., a redemption option and a fixed dividend rate) may reasonably be assessed as containing a debt host, even when there is a conversion option, if there is significant uncertainty about whether the option will be in-the-money by the redemption date. Determining whether a hybrid preferred equity instrument is a fixed income investment with an equity kicker (debt host) or an overall equity investment (equity host) will require well-reasoned judgment in these circumstances.
PwC observation:
Upon completion of the embedded derivative analysis, the investor must determine the appropriate accounting for the host contract. If a hybrid preferred equity instrument meets the definition of a security, it must be analyzed under ASC 320 to determine whether it is a debt security or equity security. In contrast to the analysis of the nature of host contract, the existence of an investor redemption option is determinative under ASC 320 that the instrument should be classified as a debt security, irrespective of the conclusion as to the nature of the host contract for purposes of embedded derivative accounting. This potential inconsistency was acknowledged by the Task Force during its discussions.

Consequently, an issuer or investor’s balance sheet classification of a hybrid preferred equity instrument does not determine the nature of the host contract when analyzing embedded features for bifurcation and separate accounting.

19 Reporting entities should use judgment when determining how individual terms or features should be weighted when determining the nature of the host contract. The conclusion should consider all of the instrument’s relevant terms and features, and the facts and circumstances specific to the instrument being evaluated.

Additional factors to consider
20 The ASU provides additional implementation guidance to help reporting entities determine the nature of a hybrid preferred equity host contract. The incremental guidance is intended to help illustrate when certain terms and features should be weighted more or less heavily when determining the nature of the host contract and how specific facts and circumstances may impact the weighting.

21 The ASU provides the following indicators that a reporting entity should consider when determining the relative importance of the terms and features identified:

- The characteristics of the relevant terms and features (e.g., whether they are contingently exercisable only upon the occurrence of a specific event, and whether they are in-the-money or out-of-the-money)
- The circumstances under which the hybrid financial instrument was issued or acquired (e.g., issuer-specific characteristics, such as whether the entity is thinly capitalized or profitable and well-capitalized)
- The potential outcomes of the hybrid financial instrument (e.g., whether the instrument may be settled by issuing a fixed number of common shares or transferring a specified amount of cash, or remain perpetual legal-form equity), as well as the likelihood of those outcomes.

PwC observation:
The analysis is intended to be qualitative in nature. The introduction of specific factors to consider when assessing the nature of the host contract provides reporting entities with a robust framework to guide their evaluation. This analysis should also be informed by an entity’s expectation of the potential expected outcomes at the date the analysis is performed. That is, an entity should assess the substance of the instrument and consider whether the investor’s expectation was to principally invest in an instrument for a return that is more debt-like or equity-like.
**Redemption rights**

.22 The implementation guidance requires that the significance of a fixed-price redemption option be considered and compared to the significance of all other features of the hybrid instrument when determining its impact on the host contract determination. When assessing the relative weighting of a redemption feature, the following facts and circumstances should be considered:

- Whether the redemption right is currently exercisable or becomes exercisable solely due to the passage of time (non-contingent), or requires an event to occur prior to it becoming exercisable (contingent)
- Whether redemption is mandatory, or if not mandatory, whether the redemption right is held by the issuer or the investor
- Whether the redemption right is in-the-money or out-of-the-money
- Whether laws exist that would restrict the issuer or investors from exercising the redemption right
- The ability of the issuer to cash settle the instrument if the redemption right is exercised (i.e., consider the issuer’s capitalization and level of profitability)
- If the hybrid preferred equity instrument is also redeemable, the extent to which the redemption price is more or less favorable than the stated conversion price. Also consider whether conversion is more likely to occur before redemption

**Conversion rights**

.23 When assessing the relative importance of a conversion feature (e.g., preferred stock convertible into a fixed number of common shares), the following factors should be considered when determining the level of weighting ascribed:

- Whether the conversion right is contingent or non-contingent
- Whether the conversion right is held by the issuer or investors
- Whether conversion is mandatory or becomes mandatory following the occurrence or non-occurrence of a specified event (e.g., an IPO)
- Whether the conversion feature is in-the-money or out-of-the-money
- If the hybrid preferred equity instrument is also redeemable at the option of the investors, whether conversion is more likely to occur before the redemption right becomes exercisable
PwC observation:
The existence of a non-contingent conversion option that is exercisable by the investor may be a stronger equity-like indicator than a contingently exercisable conversion option.

In addition, the probability that a conversion option will be exercised should be considered when evaluating the weight to ascribe to that feature in the host contract analysis. This probability will partly depend on the extent to which the option is in or out-of-the-money.

Voting rights and dividend rights
.24 A hybrid preferred equity instrument may include other equity-like features that should be considered when determining the nature of the host contract. If the contractual terms of the hybrid instrument allow the holder to exercise voting rights on an “as-converted” basis, the significance of the matters the holder is entitled to vote on and the level of influence it may exercise through those voting rights should be considered. Voting rights that allow the holder to vote on all significant matters may be weighted more heavily in the host contract determination analysis. Alternatively, the ability of the holder to vote only on rights that are expected to occur outside the ordinary course of business (i.e., protective rights) is less persuasive evidence that the host contract is equity.

.25 Some hybrid preferred equity instruments provide the holder with rights to dividends. Reporting entities should assess the nature of those dividends when determining whether that feature is more debt- or equity-like. The following factors may help inform a reporting entity’s determination of the relative importance of a dividend right:

- Whether the dividends are mandatory or discretionary

- The basis on which dividends are determined, and whether those dividends are stated (for example, a fixed percent of liquidation preference) or vary based on dividends paid to common holders (often referred to as participating dividends)

- Whether the dividends are cumulative or non-cumulative

PwC observation:
Mandatory fixed-rate, cumulative dividends are an indicator the host is more akin to debt, whereas non-cumulative discretionary dividends may indicate the host is more akin to equity.

When evaluating the relative importance of equity-like dividend rights, we believe consideration should be given to the past dividend practices of the issuer. If the issuer does not have a past practice of paying dividends and is not expected to pay dividends in the future, we believe the dividend rights should be considered a less persuasive indicator of an equity host contract.
Protective covenants

.26 Although protective covenants are generally viewed to indicate the host contract is more akin to debt, the nature of the covenant should be considered in determining the relative weight ascribed in the analysis. Hybrid preferred equity instruments that contain collateral requirements or provide the investor with creditor-like rights (for example, the right to force the issuer into bankruptcy) should be weighted more heavily in the host contract determination. Similarly, if the issuer’s parent has guaranteed its performance upon redemption (which is a debt-like feature), the feature should be weighted more heavily in the host contract determination.

What’s next

.27 The amendments to ASC 815 introduced by the ASU will be effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For calendar year-end public business entities, the ASU is effective on January 1, 2016. The ASU is effective for non-public business entities for fiscal years beginning after December 15, 2015 and interim periods within fiscal years beginning after December 15, 2016.

.28 Early adoption of the ASU, including adoption in an interim period, is permitted. Adoption of the ASU during an interim period will require a reporting entity to apply the adjustments as if adoption had occurred at the beginning of the fiscal year of adoption.

.29 The ASU should be adopted on a modified retrospective basis to instruments outstanding as of the beginning of the period of adoption. Retrospective application is permitted to all relevant prior periods. Upon adoption, reporting entities must assess all existing hybrid preferred equity instruments to determine whether they include one or more embedded features that require bifurcation and separate accounting. In doing so, the reporting entity must reassess the economic characteristics and risks of the host contract to determine whether such features are clearly and closely related to the host contract.

PwC observation:
If the modified retrospective transition alternative is elected, reporting entities would not apply the ASU to hybrid preferred equity instruments settled prior to the period of adoption.

.30 The transitional assessment of the nature of the host contract is made as of the issuance or acquisition date of the investment. If one or more features embedded in a hybrid preferred equity instrument that have been previously bifurcated no longer require bifurcation and separate accounting upon adoption of the ASU, such host contract and previously separated features should be recombined and accounted for as a single unit of account. The carrying amount of the recombined instrument should equal the adoption date carrying amount of the host contract and the fair value of the previously bifurcated feature (i.e., no cumulative-effective adjustment is required).

.31 A reporting entity may have previously issued (or invested in) a hybrid preferred equity instrument that included an embedded feature that was not separated from the host contract, but for which adoption will now require that the embedded feature be accounted for separate from the host contract. The effective date carrying value of such host contract should be based on the hypothetical carrying value of the instrument had the feature been bifurcated and accounted for separately on the original issuance (or acquisition) date. The embedded feature that must be bifurcated should be recognized and measured based on its fair value on the date of adoption. The transition adjustment (i.e., the difference between the new carrying value of the host contract and bifurcated...
embedded feature, and the previous carrying value of the hybrid instrument) should be recorded directly through retained earnings as a cumulative-effective adjustment.

.32 Reporting entities may also adopt the ASU on a full retrospective basis. If this transition method is elected, the changes introduced by the ASU would also be applicable to hybrid financial instruments issued in the form of a share that were settled in any comparative periods presented in the reporting entity’s financial statements.
Appendix: Illustrative examples

Example 1: Convertible, redeemable preferred equity issued by a thinly capitalized entity

Company A, an early stage software company, developed a software solution that is licensed to small and medium-sized enterprises. In its most recent fiscal year, Company A recorded sales of $6 million, a 200% increase over the prior year, and a net loss of $2 million. Management estimates that existing cash on hand is sufficient to fund Company A’s operations for an additional 3 months.

To date, Company A has raised $7 million of equity financing (common stock) and $4 million of debt financing (bank debt). Company A has not historically paid dividends and it does not expect to do so in the near to intermediate term.

To raise capital to finance its future operating needs, Company A issued Series A preferred stock with a $2 million par value ($2.00 per share) to a single investor, Company X. All capital raised by Company A will be utilized to increase the size of its sales force and enhance its current software development capabilities.

The key terms of the Series A preferred stock are:

- 8% cumulative, fixed-rate dividends (increases the liquidation preference if not paid in cash)
- Convertible into common stock on a 1:1 basis anytime at the option of the holder
- Automatically converts into common stock upon an initial public offering or sale of the company
- Redeemable at the option of the holder after 5 years for cash equal to the par value of the Series A preferred stock plus accrued and unpaid dividends
- Voting rights on all significant matters submitted for common stockholder vote on an as-converted basis
- Participates in common stock dividends on an as-converted basis
- No creditor rights
- No collateral requirements

The fair value of Company A’s common equity was $1.40 per share on the date the preferred stock was issued. Company A’s stock price is volatile and could change significantly based on future sales and profitability.

At the time the Series A preferred stock was issued, Company A reported an accumulated deficit of $7 million. Based on its current capitalization and stage of operations, there is significant uncertainty regarding Company A’s ability to settle the redemption feature in five years, if exercised. Although Company A’s current financial position is tenuous, Company X expects the business to perform well over time and to exit its investment through conversion into Company A’s common equity (through a public offering).

Is the nature of the host contract more debt-like or equity-like?

When considering all relevant terms and features (i.e., the “whole instrument” approach), the host contract should be considered an equity host.

The existence of cumulative, fixed-rate dividends and a non-contingent redemption feature that is exercisable in five years may indicate the existence of a debt host. However, mitigating considerations exist, including the fact that the realization of
these dividends may be tied to the redemption of the instrument, which may not occur, and if redemption is required, there is significant uncertainty as to Company A’s financial wherewithal to fund those dividends.

In contrast, the conversion feature would appear to be a strong indicator that the host contract is more akin to an equity host contract. At the time Company X acquired the Series A preferred stock, Company X understood that Company A might encounter going concern issues if an initial public offering or sale of the company did not occur, and that its economic return was therefore tied to a successful initial public offering or sale.

Other equity-like terms and features include the voting rights and common stock dividend participation rights. Because Company X has the ability to vote on all significant matters submitted for shareholder vote, the voting feature should be weighed more heavily in the host contract determination than if they were only permitted to vote on protective matters. The ability of Company X to participate in common stock dividends on an as-converted basis should not heavily influence the host contract determination, because Company A has not paid, and is not expected to pay dividends to common shareholders in the near term. The investor’s return of and on its capital is highly dependent upon the business performing successfully and an expected exit through the conversion feature.

Although the Series A preferred stock is redeemable at the option of Company X after five years, the instrument’s payoff profile is inconsistent with a fixed-income investment with the upside of a residual interest through the conversion feature. If the redemption feature is exercised, Company A may lack sufficient assets to redeem the instrument, or may be legally prohibited from doing so if that action would cause Company A to become insolvent. Given Company A’s current financial position and the uncertainty regarding its wherewithal to perform under this potential future obligation, the redemption feature should not be weighed heavily in the host contract determination. This suggests the Series A preferred stock is, in substance, a residual interest in Company A.

The host contract contains no creditor rights that would indicate that it is more akin to a debt host contract (e.g., rights to force Company A into bankruptcy or participate in a creditor committee to force the company to reorganize or liquidate). The substance of the liquidation preference is questionable and should not heavily influence the host contract determination, because Company X is unlikely to receive cash or assets equal to a stated liquidation should the company liquidate.

Company X appears to be taking residual equity risk, and its ability to achieve a meaningful economic return is dependent upon Company A’s successful performance and undertaking of an initial public offering or sale to a third party. As a result, the considerations described above indicate that the Series A preferred stock represents an in-substance residual interest in Company A and the host contract should be considered to be equity.
Example 2: Convertible, redeemable preferred equity with creditor rights issued by a thinly capitalized entity

Assume the same facts described in Example 1; however, assume Company Y owns a majority of Company A’s common equity. Company Y is a well-capitalized public registrant with an investment-grade credit rating.

At the time Company X acquired the Series A preferred stock, significant uncertainty existed regarding the likelihood of an initial public offering. To mitigate this risk, Company X requested that Company Y guarantee Company A’s obligation to redeem the Series A preferred stock. If Company A is unable to perform upon exercise of the redemption feature, Company Y is obligated to satisfy any part of Company A’s obligation that remains unfulfilled (i.e., Company Y has guaranteed Company A’s written put option on its Series A preferred stock). If Company Y fails to perform on its guarantee, Company X may pursue legal recourse against Company Y and would have creditor rights against Company Y if it failed to perform.

Is the nature of the host contract more debt or equity-like?

When considering all relevant substantive terms and features, the host contract should be considered a debt host.

With the exception of the stated dividends, expected outcome and the non-contingent fixed-rate redemption feature, all other factors would be evaluated in a manner consistent with Example 1.

In this fact pattern, the mandatory conversion feature would be weighted less heavily given the uncertainty surrounding the likelihood of an initial public offering. This uncertainty is underscored by Company X’s request for Company Y’s guarantee of the redemption feature, as it indicates that there is a high probability that Company X will realize its investment through exercise of the redemption feature.

Although Company X may not receive the stated dividends on a current basis, it can eventually realize the value of the dividends in cash upon exercise of the redemption feature.

With respect to the redemption feature, although concerns regarding Company A’s obligation to perform if the instrument is redeemed exist, Company Y’s guarantee of Company A’s obligation to perform upon redemption influences the substance of the Series A preferred stock’s liquidation preference. Furthermore, the presence of creditor rights should Company A and Company Y fail to redeem the preferred shares upon exercise is a strong indicator of the presence of a debt host contract.

Considering the high probability that Company X will exit its investment through exercise of the redemption feature, Company Y’s guarantee of the redemption feature, the substance of the liquidation preference, and the significant risk associated with the conversion feature, the Series A preferred stock represents an in-substance fixed-income investment with residual “upside” and the host contract should be considered a debt host.
Example 3: Convertible, redeemable preferred equity with a high likelihood of conversion

In order to satisfy increased demand for its products, Company XYZ plans to finance the acquisition of new manufacturing equipment through the issuance of convertible preferred stock at a par value of $2 per share. The terms of the preferred stock are as follows:

- Redeemable at par plus accumulated and unpaid dividends upon a vote of 66% of the holders of preferred stock. The preferred stock is held by a large number of unrelated investors, none of whom individually own more than 5% of the preferred stock issued. The investor group is diverse and includes short-term investors, long-term investors, and strategic investors.
- The purpose of the redemption feature is to provide the investor group with protective rights.
- Convertible at the option of the holder after 5 years on a 1:1 basis into Company XYZ’s common shares. Company XYZ’s stock price on the issuance date is $1.80 per share.
- Voting rights on all significant matters submitted for common stockholder vote on an as-converted basis
- Participation in common stock dividends on an as-converted basis. Company XYZ has historically paid dividends on its common stock and expects to continue to do so.
- No creditor rights
- No collateral requirements

Investors in Company XYZ’s preferred stock expect to exit their investment through exercise of the embedded conversion option.

Is the nature of the host contract more debt or equity-like?

When considering all substantive relevant terms and features, the host contract should be considered an equity host.

The holder’s conversion feature is substantive and therefore should be ascribed weight in the host contract determination. In addition, the preferred stock entitles its holder to vote on all significant matters. As described in ASC815-15-25-17D(c), voting rights are generally viewed as an equity-like feature, and are given more weight in the host contract determination when the investor has the ability to vote on all significant matters (as opposed to being voting rights that are designed to be protective in nature). Finally, the preferred stock entitles its holder to participate in dividends on the same basis as the common stock holders, another equity-like feature. This feature would be weighted more heavily given that Company XYZ has historically paid dividends and expects to do so for the foreseeable future.

Although a fixed price redemption feature exists and would be considered a debt-like characteristic, this feature is considered to be more protective in nature and requires 66% of the holders of the preferred stock to vote to exercise it. Given that the preferred stock is widely held by a diverse group of investors with different investment objectives, together with the fact that none of the preferred stockholders are related parties, there are constraints to exercising the redemption feature. As such, the fixed price redemption feature is considered more protective in nature and would be ascribed less weighting in the host contract determination.

Given the additional weight ascribed to the equity-like conversion feature relative to the debt-like redemption option, and the investors’ ability to vote on all significant matters and participate in dividends with the common stock holders, the host contract should be considered an equity host.
Questions?

PwC clients who have questions about this In depth should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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