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December 16, 2013

VIA EMAIL TO: [director@FASB.org](mailto:director@FASB.org)

Technical Director  
File Reference No. EITF-13-G  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

Re: 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*

To Whom It May Concern:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions. We appreciate the opportunity to provide comments on the Board's 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* (the ED).

We believe the "pure-host" approach described in EITF Issue Summary No. 1 for Issue No. 13-G (the Issue Summary) is consistent with the guidance in Topic 815, *Derivatives and Hedging*, for determining whether the host contract in a hybrid financial instrument is more akin to debt or to equity. In our view, the "whole instrument" approach used in the ED is at variance with that guidance in Topic 815.

If the Emerging Issues Task Force (Task Force) concludes to move forward with the "whole instrument" approach, we suggest the consensus be modified such that a hybrid financial instrument issued in the form of a share that contains a *substantive* non-contingent, fixed-price redemption feature is deemed to be more akin to debt than to equity. Absent that modification, we are concerned that the proposed guidance will perpetuate the diversity in practice that currently exists with respect to the application of the whole instrument approach. Further, we believe that the existing guidance in Subtopic 815-15, *Derivatives and Hedging – Embedded Derivatives*, would need to be reviewed to identify guidance that is inconsistent with the whole instrument approach. For example, the guidance in both paragraphs 815-15-25-20 and 815-15-55-82 explicitly states that the host contract in a hybrid financial instrument issued in the form of a share with a put option is an equity host. Under the whole instrument

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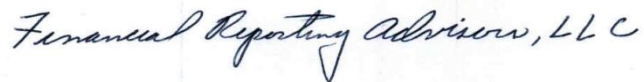
approach as described in the ED, the host contract in that situation may or may not be an equity host. We believe the guidance in paragraphs 815-15-25-20 and 815-15-55-82 will need to be revised if the Task Force moves forward with the whole instrument approach.

Attachment A responds to the questions in the ED.

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Once again we appreciate the opportunity to comment on the ED. If there are any questions, please contact Richard R. Petersen at 312-345-9102.

Sincerely,

A handwritten signature in cursive script that reads "Financial Reporting Advisors, LLC". The signature is written in black ink and is positioned above the printed name of the company.

Financial Reporting Advisors, LLC

Response to Questions

**Question 1: Should the scope of the proposed amendments be extended beyond hybrid financial instruments issued in the form of a share? If yes, please explain why and identify other hybrid instruments that should be considered by the Task Force.**

The whole instrument approach required by the ED includes consideration of the embedded derivative features when determining the nature of the host contract. For the reasons discussed below, we believe such an approach is not consistent with the general model contained in Topic 815 for evaluation of a host contract.

If the Task Force concludes to move forward with the whole instrument approach, we agree the scope of the ED should be limited to hybrid financial instruments issued in the form of a share.

**Question 2: Do you agree that a reporting entity should consider all terms and features—including the embedded derivative feature being evaluated for bifurcation—when determining whether the nature of a host contract is more akin to debt or to equity? If another method should be used, please explain that method and why it would be an improvement.**

No. We believe the “pure-host” approach described in the Issue Summary is the approach most consistent with the guidance in Subtopic 815-15 for assessing whether a host contract is more akin to debt or to equity. The Master Glossary in the Codification defines a hybrid instrument as “a contract that embodies both an embedded derivative and a host contract.” Paragraph 815-15-25-1 states that “an embedded derivative shall be separated from the host contract ....” In our view, Topic 815 is clear that a hybrid instrument is comprised of (1) a host contract and (2) one or more embedded derivatives. Paragraph 815-15-25-16 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.” That guidance simply cannot be read to be consistent with the whole instrument approach.

Because the whole instrument approach is inconsistent with the guidance in Subtopic 815-15, the ED is proposing that the nature of a host contract be determined differently for hybrid financial instruments issued in the form of a share than for other hybrid instruments. The need to determine the nature of a host contract contained in a hybrid financial instrument issued in the form of a share differently than for other hybrid instruments adds a layer of complexity to an area of accounting guidance that is already complex. In our view, this added complexity is a fatal flaw for the whole instrument approach.

We believe the following points support the use of the pure-host approach:

- The pure-host approach uses the term “host contract” in the same manner as that term is used throughout Subtopic 815-15 (that is, the host contract is a subcomponent of a hybrid financial instrument issued in the form of a share).

Master Glossary definition of a hybrid instrument: “a contract that embodies both an embedded derivative and a host contract”

Paragraph 815-15-05-1 states: “The effect of embedding a derivative instrument in another type of contract (the host contract) is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent on the occurrence of a specified event, will be modified based on one or more underlyings.”

Paragraph 815-15-25-1 states: “An embedded derivative shall be separated from the host contract ...”

- The pure-host approach is consistent with the existing guidance in Subtopic 815-15. In our view, the pure-host approach is a clarification of the existing guidance with respect to accounting for a hybrid financial instrument issued in the form of a share rather than an exception to the existing guidance.

Paragraph 815-15-25-20 states: “A put option that enables the holder to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is not clearly and closely related to that equity instrument.”

Paragraph 815-15-55-82 states: “From the investor’s perspective, the purchase of common stock with an embedded purchased put option that requires physical settlement is a hybrid instrument that shall be evaluated to determine whether it has an embedded derivative that shall be accounted for separately. The embedded purchased put option shall be separated from the equity host because the common stock and the embedded put option are not clearly and closely related ...”

Paragraph BC11 of the ED states that the Task Force considered and rejected the pure-host approach “because it believes that the approach 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.” We understand that criticism of the pure-host approach. However, that criticism applies to all aspects of the Board’s financial instruments projects over the past 20 years. For example, at the margin, it is very difficult to distinguish the economics of a subordinated convertible debt instrument and puttable common stock—yet those two instruments are analyzed and accounted for much differently. Further, the Board specifically considered a hybrid financial instrument issued in the form of a share when FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, was issued and did not adopt the whole instrument approach. Paragraph 308 from the Basis for Conclusions to Statement 133 states, in part:

“A put option embedded in an equity security has the potential to convert the equity security to cash or another asset, and conversion to cash according to the terms of the instrument is not a usual characteristic of an equity security. Accordingly, a put option embedded in an equity security is not clearly and closely related to the host contract if exercise of the put option would result in the payment of cash or delivery of another asset by the issuer of a security ...”

Consequently, we do not agree with the criticism in paragraph BC11 of the pure-host approach.

In our view, the biggest negative about the pure-host approach is that public registrants have been precluded from using this approach since the SEC staff announcement in March of 2007 (Codification paragraph 815-10-S99-3).

***Question 3: Do you agree that no single feature should be determinative in concluding whether the host contract is more akin to debt or to equity? Furthermore, do you agree that a fixed-price, non-contingent redemption option held by an investor embedded in a share is not, in and of itself, determinative in concluding that the nature of the host contract is more akin to debt? If not, please explain why.***

The following is in the context of the Task Force moving forward with the whole instrument approach. We believe that a substantive non-contingent, fixed-price redemption feature<sup>1</sup> should result in the host contract for a hybrid financial instrument issued in the form of a share being deemed to be more akin to debt than to equity. Paragraphs BC14 and BC15 identify situations in which a redemption feature may not be substantive. We agree that a non-substantive redemption feature should not result in the host contract being deemed a debt host. However, in our view, a substantive redemption feature is inconsistent with the notion of an equity host and should result in the host being deemed a debt host. We note that the Task Force previously dealt with a similar issue in EITF Issue 02-14, *Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock*, and used a notion of a “substantive redemption provision” (paragraph 323-10-15-13(c)) in assessing whether a preferred stock was “in-substance” common stock. We believe that the whole instrument approach would benefit from explicitly stating that a substantive non-contingent, fixed-price redemption feature causes the host contract to be deemed a debt host. We acknowledge that there will be judgment involved in making that determination but note that the in-substance common stock guidance appears to have been applied in practice for a number of years and therefore believe that “substantive” is an operational approach to narrowing the current diversity in practice in applying the whole instrument approach.

We also agree with the point made by the dissenting Task Force member in BC16 that it seems inconsistent for a hybrid financial instrument issued in the form of a share that contains a substantive non-contingent, fixed-price redemption feature to be considered an equity host under the whole instrument approach when that instrument meets the definition of a debt security in Topic 320, *Investments—Debt and Equity Securities*.

***Question 4: Will the proposed amendments help reduce diversity in practice with respect to determining the nature of the host contract within hybrid financial instruments issued in the form of a share? If not, please explain why.***

Absent providing that hybrid financial instruments issued in the form a share that contain a substantive non-contingent, fixed-price redemption feature are deemed a debt host, we believe there will continue to be diversity in practice in applying the whole instrument approach.

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<sup>1</sup> We are using the same definition of a “non-contingent, fixed-price redemption feature” as used by the FASB staff in paragraph 36 of the Issue Summary.