

**EMBEDDED DERIVATIVES:
HIDDEN SKELETONS IN YOUR CLOSET**

EMBEDDED DERIVATIVES

In our last Alert, we described how Down-round financings can trigger the late discovery of a derivative that was buried in a previous financing. To recap, if a company issues securities that include certain price protection features, it may need to account for that protection from day one as an embedded derivative requiring bifurcation and fair value it through earnings at each reporting period. A Down-round financing reveals the embedded derivative when price protection is exercised, as the Company is obligated to protect investors from dilution. Under EITF 07-5, *Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock (which now resides within subtopics 40 and 10 of ASC 815, Derivatives and Hedging)*, companies must account for this obligation when price protection is initially granted, not when it is exercised.

Embedded derivatives can show up in almost any contract, and unless they qualify for a hedge or are not required to be bifurcated, they are typically required to be separated from the host contract and fair valued through earnings at each reporting period. The host contract in which the derivative is embedded could be a sales contract, structured note, prepayable loan, callable bond, lease, insurance policy or preferred stock, to name only a few.

Embedded derivatives are often discovered too late. This Alert is designed to raise awareness on the topic and serve as an aid in the identification of downround protection that may be required to be bifurcated and fair valued through earnings.

EXAMPLE

The following assumptions describe a financing transaction with features that are not uncommon. Company XYZ, a private company, issues convertible preferred stock:

INVESTORS' RIGHTS	OPTIONALITY
Investors have the right to:	Put the stock back to the Company after 3 years
	Hold the preferred for the long-term
	Convert the preferred into common shares ("common") on a one-for-one basis at any time
The put contains two possibilities, both at the option of the holder:	Investors can receive their initial investment plus a 7% cumulative compounding dividend, OR
	The fair value of the preferred shares

This example reflects the following terms, conditions and assumptions:

- The preferred is the host contract and the three rights described above are considered embedded within the preferred.
- As the preferred is convertible into common shares on a one-for-one basis, the fair value of the preferred is variable and based on the fair value of the common.
- If there is a conversion, all cumulative unpaid dividends are forfeited.
- The preferred shares are non-participatory, senior to all other equity interests, and have preference in the event of liquidation.
- The preferred shareholders have a non-controlling interest, as they fill less than half the Board seats.
- The Company has determined that the preferred will be classified on the balance sheet as (mezzanine) equity, as the put does not represent an unconditional obligation of the Company to transfer assets.
- Investors' rights meet the definition of a derivative.
- An analysis must be performed to determine whether bifurcation of an embedded derivative is required.

Given the terms, conditions and assumptions described above, three years pass, the Company performs well, the Company's common shares experience greater than a 10% annual return, none of the preferred is converted, and investors choose to exercise their right to put. Since the Company's stock has shown handsome returns, investors opt to receive the fair value of the preferred, which is clearly greater than a 7% cumulative dividend. As the Company and investors need to agree on fair value, each relies on an independent valuation firm to estimate fair value.

TO BIFURCATE OR NOT TO BIFURCATE

Just because the put is an embedded derivative does not automatically mean that it has to be separated from the host contract and fair valued. We assumed above that investors' rights meet the definition of an embedded derivative. The next step is to figure out whether the embedded derivative is "clearly and closely related" to the host contract. This is done by evaluating the risks and characteristics of the host contract and comparing them to the risks and characteristics of the embedded derivative. If the embedded derivative is not considered clearly and closely related to the host contract, it must be bifurcated.

For example, a host contract with characteristics of equity would not be considered clearly and closely related to an embedded derivative with characteristics of debt, as debt and equity are completely different. For this example, we assumed above that the convertible preferred shares are classified as equity on the balance sheet. However, for purposes of determining whether an embedded derivative is clearly and closely related to a host contract, the balance sheet classification as (mezzanine) equity does not automatically carry over. This is where the trouble begins.

For purposes of evaluating how clearly and closely related the embedded derivative is to the host contract, the preferred shares in this example have characteristics of both equity and debt. Deciding which characteristics tip the scale requires judgment. The preferred's equity characteristics include share settlement upon any conversion, board seats, and voting rights. Its debt characteristics include the possibility of redemption, a minimum fixed return of 7%, a lack of participation rights, and the fact that it is senior to all other equity interests. Many companies would conclude, and their auditors would agree, that the debt characteristics outweigh the equity characteristics.

Therefore, while the host contract would be considered an equity instrument for balance sheet classification purposes, it is a debt instrument for purposes of determining whether the embedded derivative is clearly and closely related to the host contract (the preferred shares). Many companies improperly assume that the balance sheet classification carries over to the bifurcation analysis. It may not. The last step is to evaluate the risks and characteristics of the embedded derivative. We said earlier that investors have 3 rights: put, convert or hold. All three of these rights have the risks and characteristics of equity. The Company is left with an equity instrument embedded in a debt instrument. There is no clear and close relationship between the two, so therefore bifurcation is required, and fair value must be determined at each reporting period, with changes in fair value flowing through earnings.

FAIR VALUE

Depending on whether the Company is public or private and how often the Company's shares trade, the fair value of the embedded derivative would be determined using a combination of techniques, including an option pricing model and observations of market activity.

CONCLUSION

Embedded derivatives are complex financial instruments. A failure to properly account for derivatives has caused more than a few Fortune 500 companies to restate their financial statements for multiple reporting periods, including General Electric, Fannie Mae, Freddie Mac, Bank of America, Ford Motor Company and AIG. Consult with your auditors early on in the transaction and seek an independent third party valuation services provider both for financial reporting and strategic and management planning purposes.

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