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BDO FLASH REPORT
FASB

SUBJECT

FASB ISSUES ASU ON CONTINGENT PUT AND CALL OPTIONS IN DEBT INSTRUMENTS

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SUMMARY

The FASB recently issued ASU 2016-06[1] on how to assess whether contingent call (put) options that can accelerate the payment on debt instruments are clearly and closely related to their debt hosts. This assessment is necessary to determine if the option(s) must be separately accounted for as a derivative. The ASU clarifies that an entity is required to assess the embedded call (put) options *solely* in accordance with a specific four-step decision sequence. This means entities are not *also* required to assess whether the contingency for exercising the option(s) is indexed to interest rates or credit risk. The ASU is available here and becomes effective for public entities in 2017. Early adoption is allowed.

DETAILS

Background

Topic 815[2] requires that embedded derivatives be bifurcated from the host contract and accounted for separately as derivatives if certain criteria are met. One of those criteria is that the economic characteristics and risks of the embedded derivatives are not clearly and closely related to the economic characteristics and risks of the host contract. For example, this guidance addresses whether a put feature in a loan that is exercisable upon a change of control of the issuer should be bifurcated and separately accounted for as a derivative.

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[1] *Contingent Put and Call Options in Debt Instruments*
[2] Derivatives and Hedging

More specifically, paragraph 815-15-25-42 provides a four-step decision sequence for determining whether call (put) options that can accelerate the settlement of debt instruments are clearly and closely related to the debt host contract. Those four factors consider whether:

i. the payoff is adjusted based on changes in an index
ii. the payoff is indexed to an underlying besides interest rates or credit risk
iii. the debt payoff involves a substantial premium or discount, and
iv. the call (put) option is contingently exercisable.

Diversity in practice exists currently whereby some entities assess whether the event that triggers the ability to exercise the call (put) option is indexed only to interest rates or credit risk, in addition to applying the four-step decision sequence. Other entities solely apply the four-step decision sequence.

Main Provisions

Under the ASU, entities that are issuers of or investors in debt instruments (or hybrid financial instruments that are determined to have a debt host) should not analyze whether the event that triggers the ability to exercise the call (put) option is indexed only to interest rates or credit risk. Rather, an entity is solely required to assess the embedded call (put) options under the four-step decision sequence summarized above. For example, when evaluating debt instruments puttable upon a change in control, the event triggering the change in control is not relevant to the assessment. Only the resulting settlement of debt is subject to the four-step decision sequence.

Effective Date and Transition

The amendments are effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption is permitted. However, If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of that fiscal year.

The amendments must be applied on a modified retrospective basis to existing debt instruments as of the beginning of the fiscal year for which the amendments are effective.

If an entity previously bifurcated an embedded derivative but is no longer required to do so under the ASU, the fair value of the derivative should be combined with the book value of the debt instrument upon adoption. At that time, an entity will have a one-time option to elect to measure the combined debt instrument at fair value with changes in fair value recognized in earnings under Topic 825.[3] Alternatively, an entity should apply other U.S. GAAP to the debt instrument. Certain additional transition provisions apply.

[3] Financial Instruments