

FINANCIAL ACCOUNTING SERIES



ACCOUNTING STANDARDS UPDATE

No. 2016-06
March 2016

Derivatives and Hedging (Topic 815)

Contingent Put and Call Options in Debt Instruments

a consensus of the FASB Emerging Issues Task Force

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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Summary

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

Topic 815, Derivatives and Hedging, requires that embedded derivatives be separated 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 (the “clearly and closely related” criterion).

Generally accepted accounting principles (GAAP) provide specific guidance for assessing whether call (put) options that can accelerate the repayment of principal on a debt instrument meet the clearly and closely related criterion. The guidance states that for contingent call (put) options to be considered clearly and closely related, they can be indexed only to interest rates or credit risk. However, that guidance raised interpretative questions that the Derivatives Implementation Group (DIG) tried to clarify through implementation guidance in a four-step decision sequence applicable to all call (put) options. The four-step decision sequence requires an entity to consider whether (1) the payoff is adjusted based on changes in an index, (2) the payoff is indexed to an underlying other than interest rates or credit risk, (3) the debt involves a substantial premium or discount, and (4) the call (put) option is contingently exercisable.

Questions emerged about how the four-step decision sequence interacts with the original guidance for assessing embedded contingent call (put) options in debt instruments. Two divergent approaches developed in practice. Under the first approach, the assessment of whether contingent call (put) options are clearly and closely related to the debt host only requires an analysis of the four-step decision sequence. Under the second approach, an assessment of whether the event that triggers the ability to exercise the call (put) option is indexed only to interest rates or credit risk is required in addition to the four-step decision sequence. Those two approaches, which resulted from different interpretations of the intent of the four-step decision sequence, may result in different conclusions about whether the embedded call (put) option is clearly and closely related to its debt host, and, thus, may result in different conclusions about which call (put) options should be bifurcated and accounted for separately as derivatives.

The amendments in this Update are intended to resolve the diversity in practice resulting from those two approaches.

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 debt instruments (or hybrid financial instruments that are determined to have a debt host) with embedded call (put) options.

What Are the Main Provisions?

The amendments in this Update clarify the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. An entity performing the assessment under the amendments in this Update is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence.

How Do the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The amendments in this Update clarify what steps are required when assessing whether the economic characteristics and risks of call (put) options are clearly and closely related to the economic characteristics and risks of their debt hosts, which is one of the criteria for bifurcating an embedded derivative. Consequently, when a call (put) option is contingently exercisable, an entity does not have to assess whether the event that triggers the ability to exercise a call (put) option is related to interest rates or credit risks. The amendments are an improvement to GAAP because they eliminate diversity in practice in assessing embedded contingent call (put) options in debt instruments.

When Will the Amendments Be Effective?

For public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years.

For entities other than public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018.

An entity should apply the amendments in this Update 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 had bifurcated an embedded derivative

but is no longer required to do so as a result of applying the amendments, the aggregate of the carrying amount of the debt host contract and the fair value of the previously bifurcated embedded derivative will become the carrying amount of the debt instrument at the date of adoption.

If an entity is no longer required to bifurcate an embedded derivative as a result of applying the amendments in this Update, the entity has a one-time option, as of the beginning of the fiscal year for which the amendments are effective, to irrevocably elect to measure that debt instrument in its entirety at fair value with changes in fair value recognized in earnings. For those instruments for which the entity elects fair value, the effects of initially complying with the amendments as of the effective date should be reported as a cumulative-effect adjustment directly to retained earnings as of the beginning of the fiscal year for which the amendments are effective. The entity should elect fair value on an instrument-by-instrument basis.

Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

Amendments to the *FASB Accounting Standards Codification*[®]

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–5. In some cases, to put the change in 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 815-15-25-37 and 815-15-25-41 through 25-42 and supersede paragraph 815-15-25-40, with a link to transition paragraph 815-15-65-3, as follows:

Derivatives and Hedging—Embedded Derivatives

Recognition

> Applying the Clearly-and-Closely Related Criterion

> > Host Contracts with Debt Characteristics

> > > Interest-Rate-Related Underlyings

815-15-25-26 For purposes of applying the provisions of paragraph 815-15-25-1, an embedded derivative in which the only **underlying** is an interest rate or interest rate index (such as an interest rate cap or an interest rate collar) that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract that is considered a debt instrument is considered to be clearly and closely related to the host contract unless either of the following conditions exists:

- a. The hybrid instrument can contractually be settled in such a way that the investor (the holder or the creditor) would not recover substantially all of its initial recorded investment (that is, the embedded derivative contains a provision that permits any possibility whatsoever that the investor's [the holder's or the creditor's] undiscounted net cash inflows over the life of

- the instrument would not recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms).
- b. The embedded derivative meets both of the following conditions:
 1. There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract (that is, the embedded derivative contains a provision that could under any possibility whatsoever at least double the investor's initial rate of return on the host contract).
 2. For any of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed in (b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under the relevant future interest rate scenario) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception.

> > > Exception for Call Options Exercisable Only by the Debtor

815-15-25-37 The conditions in paragraph 815-15-25-26(b) do not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor (the issuer or the borrower). This guidance does not affect the application of the condition in paragraph 815-15-25-26(a) or the application of paragraphs ~~815-15-25-41~~~~815-15-25-40~~ through 25-43. In addition, this guidance does not apply to other embedded derivative features that may be present in the same hybrid instrument.

> > > Call Options and Put Options on Debt Instruments

815-15-25-40 Paragraph superseded by Accounting Standards Update No. 2016-06. ~~Provided the call (put) options also are considered to be clearly and closely related to the debt host contract under paragraph 815-15-25-26, call (put) options that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt instrument that requires principal repayments unless both of the following conditions exist:~~

- a. ~~The debt involves a substantial premium or discount (which is common with zero coupon bonds).~~
- b. ~~The call (put) option is only contingently exercisable.~~

815-15-25-41 ~~For contingently exercisable call (put) options to be considered clearly and closely related, they can be indexed only to interest rates or credit risk,~~

~~not some extraneous event or factor. In contrast, call~~ Call (put) options that do not accelerate the repayment of principal on a debt instrument but instead require a cash settlement that is equal to the price of the option at the date of exercise would not be considered to be clearly and closely related to the debt instrument in which it is embedded.

815-15-25-42 The following four-step decision sequence shall be followed in determining whether call (put) options that can accelerate the settlement of debt instruments shall be considered to be clearly and closely related to the debt host contract:

Step 1: Is the amount paid upon settlement (also referred to as the payoff) adjusted based on changes in an index ~~(rather than simply being the repayment of principal at par, together with any unpaid accrued interest)?~~ If yes, continue to Step 2. If no, continue to Step 3.

Step 2: Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, then that embedded feature is not clearly and closely related to the debt host contract and further analysis under Steps 3 and 4 is not required. If no, then that embedded feature shall be analyzed further under Steps 3 and 4 ~~as well as under the provisions of paragraphs 815-15-25-1 and 815-15-25-26.~~

Step 3: Does the debt involve a substantial premium or discount? If yes, continue to Step 4. If no, ~~in accordance with paragraphs 815-15-25-40 through 25-41,~~ further analysis of the contract under paragraph 815-15-25-26 is required, ~~required to determine whether the call (put) option is clearly and closely related to the debt host contract if paragraph 815-15-25-26 is applicable.~~

Step 4: Does a contingently exercisable call (put) option accelerate the repayment of the contractual principal amount? If yes, the call (put) option is not clearly and closely related to the debt instrument. If not contingently exercisable, ~~in accordance with paragraphs 815-15-25-40 through 25-41,~~ further analysis of the contract under paragraph 815-15-25-26 is required to determine whether the call (put) option is clearly and closely related to the debt host contract, if applicable.

815-15-25-43 The preceding paragraph is distinct from paragraph 815-15-25-37, which addresses whether the conditions in paragraph 815-15-25-26(b) involving rate of return apply to certain call options exercisable only by the debtor. Paragraph 815-15-55-13 illustrates the application of the guidance in the preceding paragraph to nine illustrative debt instruments.

3. Amend paragraphs 815-15-55-35, 815-15-55-37, 815-15-55-39, 815-15-55-43, 815-15-55-45, 815-15-55-47, and 815-15-55-124, with a link to transition paragraph 815-15-65-3, as follows:

Implementation Guidance and Illustrations

> Implementation Guidance

> > > > Alternative Remarketable Put Bond Structures

> > > > > Structure 1

815-15-55-35 Structure 1 is analyzed as follows:

- a. Investment bank's held call option. The debtor should not account for the call option purchased by the investment bank from the investor. The debtor is not a party to the call option. The investor's accounting for Structure 1 is addressed in Example 1, Case A (see paragraph 815-10-55-67), which requires that an option that is added to a debt instrument by a third party contemporaneously with or after the issuance of the debt instrument be separately accounted for as a derivative instrument by the investor. That is, it shall be reported at fair value with changes in value recognized currently in earnings. The investment bank shall also account for a freestanding purchased call option.
- b. Investor's written call option. The carrying value of the investor's attached freestanding written call option to the investment bank should be its fair value in accordance with paragraphs 815-10-30-1 and 815-10-35-1. The remaining proceeds would be allocated to the carrying amount of the puttable bond.
- c. Investor's held put option. Neither the debtor nor the investor is required to account separately for the embedded put option written by the debtor to the investor. Under paragraphs ~~815-15-25-41~~~~815-15-25-40~~ through 25-43, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

> > > > > Structure 2

815-15-55-37 Structure 2 is analyzed as follows:

- a. Investment bank's held call option. The debtor should not account separately for the call option that is purchased from the investor after it is transferred to the investment bank. The debtor is no longer a party to the call option. The investor's accounting for Structure 2 is addressed in

Example 1, Case B (see paragraph 815-10-55-70), which indicates that the investor's written call option is a separate freestanding derivative instrument that shall be reported at fair value with changes in value recognized currently in earnings. The investment bank shall also account for a freestanding purchased call option.

- b. Investor's written call option. The carrying value of the investor's freestanding written call option to the investment bank should be its fair value in accordance with paragraphs 815-10-30-1 and 815-10-35-1. The remaining proceeds would be allocated to the carrying amount of the puttable bond.
- c. Investor's held put option. Neither the debtor nor the investor is required to account separately for the embedded put option written by the debtor to the investor. Under paragraphs 815-15-25-41~~815-15-25-40~~ through 25-43, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

> > > > > **Structure 3**

815-15-55-39 Structure 3 is analyzed as follows:

- a. Investment bank's held call option. The debtor shall account separately for the freestanding call option written to the investment bank, and the investment bank shall account for a freestanding purchased call option, in accordance with the guidance for a derivative instrument in Subtopic 815-10. The investor is not a party to that freestanding written call option and therefore should not account for that option. In addition to the freestanding call option held by the investment bank, Structure 3 also involves an embedded call option written by the investor to the debtor. That embedded call option is not required to be accounted for separately by either the debtor or the investor. Under paragraphs 815-15-25-41~~815-15-25-40~~ through 25-43, that embedded call option is considered clearly and closely related to the economic characteristics of the bond. Consistent with the guidance in paragraph 815-20-25-43(c)(7), the debtor may not designate its freestanding call option written to the investment bank as a hedge of its embedded call option purchased from the investor. Because the terms of the contractual agreement require the debtor to settle its obligation to the investor on the embedded options' exercise date, that exercise date is essentially the bond's actual maturity date. Thus, in this structure, there is no embedded option in the bond that would qualify as the hedged item in a **fair value hedge** in which the hedging instrument is the debtor's freestanding written call option to the investment bank. However, the debtor may designate its freestanding written call option as a hedge of another asset or liability provided that all applicable requirements, including those in paragraph 815-20-25-94, are met.

- b. Investor's held put option. Neither the debtor nor the investor is required to account separately for the embedded put option written by the debtor to the investor. Under paragraphs ~~815-15-25-41~~~~815-15-25-40~~ through 25-43, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

> > > > Structure 4 (Trust-Based Format)

815-15-55-43 Structure 4 is analyzed as follows:

- a. Investment bank's held call option. Neither the debtor nor the investor should account for the call option purchased by the investment bank from the trust because neither is a party to that call option. (However, if either the debtor or the investor is required to consolidate the trust, that consolidation will require recognition of the call option written by the trust to the investment bank.) The investment bank shall account for a freestanding purchased call option.
- b. Investor's held put option. Neither the debtor nor the investor should account separately for the embedded put option written by the debtor to the trust. From the debtor's perspective, the put option is considered clearly and closely related to the economic characteristics of the bond under paragraphs ~~815-15-25-41~~~~815-15-25-40~~ through 25-43 because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent. The investor is not a party to the embedded put option; rather, the investor simply purchased beneficial interests that mature on the put date.

> > > > Structure 5 (Remarketing Format)

815-15-55-45 Structure 5 is analyzed as follows:

- a. Investment bank's held call option. The debtor should not account separately for the call option held by the investment bank. For accounting purposes, the transaction should be viewed as a purchase of a transferable, freestanding call option by the debtor from the investor and a concurrent transfer by the debtor of that option to the investment bank. Upon that transfer, the debtor is no longer a party to the call option and has surrendered its right to prepay the debt. The investment bank acquired the debtor's right to call the bond and relieved the debtor of the obligation to pay the investor the par amount of the bond upon exercise of the call option. The call option is a contract between the investment bank and the investor that permits the investment bank to purchase the bonds from the investor at par. From the investor's perspective, that contract is a freestanding written call option that shall be accounted for in accordance with paragraphs 815-10-25-1, 815-10-30-1, and 815-10-35-1 through 35-2. That is consistent with the guidance in paragraph 815-

10-15-7—an option on a bond incorporated into the terms of the bond at inception that, by the terms of the agreement, is exercisable by a party other than either the debtor or the investor should be considered an attached freestanding derivative instrument. The investment bank shall also account for a freestanding purchased call option.

- b. Investor's written call option. The carrying value of the investor's freestanding written call option to the investment bank should be its fair value in accordance with paragraphs 815-10-30-1 and 815-10-35-1. In the remarketing format, the transfer of the purchased call option is concurrent with the issuance of the bond. The remaining proceeds would be allocated to the carrying amount of the puttable bond. The debtor recognizes no gain or loss upon the transfer of the option to the investment bank.
- c. Investor's held put option. Neither the debtor nor the investor should account separately for the embedded put option written by the debtor to the investor. Under paragraphs 815-15-25-41~~815-15-25-40~~ through 25-43, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

> > > > > **Structure 6 (Assignment Format)**

815-15-55-47 Structure 6 is analyzed as follows:

- a. Investment bank's held call option. The debtor is not required to account separately for the call option after its transfer to the investment bank. The debtor purchased a transferable freestanding call option from the investor and transferred that option to the investment bank. Therefore, after the transfer, the debtor is no longer a party to the call option and has surrendered its right to prepay the debt. The investment bank acquired the debtor's right to call the bond and relieved the debtor of the obligation to pay the investor the par amount of the bond upon exercise of the call option. Ultimately, the call option is a contract between the investment bank and the investor that permits the investment bank to purchase the bond from the investor at par. From the investor's perspective, that contract is a freestanding written call option that shall be accounted for in accordance with the guidance for a derivative instrument in Subtopic 815-10. That is consistent with the guidance in paragraph 815-10-15-7 that an option on a bond incorporated into the terms of the bond at inception that is explicitly transferable should be considered an attached, freestanding derivative instrument. The investment bank shall also account for a freestanding purchased call option.
- b. Investor's written call option. The carrying value of the investor's freestanding written call option to the investment bank should be its fair value in accordance with paragraphs 815-10-30-1 and 815-10-35-1 with the remaining proceeds allocated to the carrying amount of the puttable

bond. In the assignment format, the transfer of the purchased call option by the debtor to the investment bank may not be concurrent with the issuance of the bond. The debtor recognizes no gain or loss upon the transfer of the call option. In transactions involving a delay between the issuance of the bond and the transfer of the assignable call option to the investment bank, the allocation of the initial proceeds to the carrying value of the option would be equal to the fair value of the option. The remaining proceeds would be allocated to the carrying amount of the puttable bond. During any period of time between the initial issuance of the bond and the transfer of the call option to the investment bank, the call option shall be measured at fair value with changes in value recognized in earnings as required by paragraph 815-20-35-1. As a result of the requirement to measure the call option at fair value during the time period before it is assigned to the investment bank, the debtor would not recognize a gain or loss upon the assignment because the proceeds paid by the investment bank would be the option's current fair value on the date of the assignment, which would be the option's carrying amount at that point in time. Any change in the fair value of the option during the time period before it is assigned to the investment bank would be attributable to the passage of time and changes in market conditions.

- c. Investor's held put option. Neither the debtor nor the investor should account separately for the embedded put option written by the debtor to the investor. Under paragraphs ~~815-15-25-41~~~~815-15-25-40~~ through 25-43, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

> Illustrations

> > Example 9: Clearly and Closely Related Criterion—Market-Adjusted Value Prepayment Options

815-15-55-124 Because the criteria in paragraphs 815-15-25-26 and ~~815-15-25-41~~~~815-15-25-40~~ through 25-43 are not met, the embedded derivative (prepayment option) is clearly and closely related to the host debt contract.

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

> Transition Related to Accounting Standards Update No. 2016-06, *Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments*

815-15-65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-06, *Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments*:

- a. For **public business entities**, the pending content that links to this paragraph shall be effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years.
- b. For all other entities, the pending content that links to this paragraph shall be effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018.
- c. An entity shall apply the pending content that links to this paragraph to existing debt instruments on a modified retrospective basis as of the beginning of the fiscal year for which the pending content that links to this paragraph is effective. If an entity had bifurcated an embedded derivative but is no longer required to do so as a result of applying the pending content that links to this paragraph, the aggregate of the carrying amount of the debt host contract and the fair value of the previously bifurcated embedded derivative shall be the carrying amount of the debt instrument at the date of adoption. The premium or discount that results from the application of the pending content that links to this paragraph should not affect the entity's assessment of whether the call (put) option is clearly and closely related to the debt instrument. That is, for the purpose of the embedded derivative analysis, upon adoption, an entity shall consider the economic characteristics and risks of the host contract and the call (put) option as they existed at the date of initial recognition of the instrument (upon issuance or acquisition). No cumulative-effect adjustment to beginning retained earnings for the period of adoption is warranted.
- d. If an entity had bifurcated an embedded derivative but is no longer required to do so as a result of applying the pending content that links to this paragraph, the entity will have a one-time option, as of the beginning of the fiscal year for which the pending content that links to this paragraph is effective, to irrevocably elect to measure that debt instrument in its entirety at fair value with changes in fair value recognized in earnings if that instrument is within the scope of paragraphs 825-10-15-4 through 15-5. For those instruments for which the entity elects fair value, the effects of initially complying with the pending content that links to this paragraph shall be reported as a cumulative-effect adjustment directly to retained earnings as of the beginning of the fiscal year in which the pending content that links to this paragraph is adopted.
- e. Earlier application of the pending content that links to this paragraph is permitted, including adoption in an interim period. If an entity early adopts the pending content that links to this paragraph in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.
- f. An entity shall provide the disclosures in paragraphs 250-10-50-1(a) and (b)(3) and 250-10-50-2, as applicable, in the period the entity adopts the pending content that links to this paragraph.

Amendments to Status Sections

5. 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.

Paragraph	Action	Accounting Standards Update	Date
815-15-25-37	Amended	2016-06	03/14/2016
815-15-25-40	Superseded	2016-06	03/14/2016
815-15-25-41	Amended	2016-06	03/14/2016
815-15-25-42	Amended	2016-06	03/14/2016
815-15-55-35	Amended	2016-06	03/14/2016
815-15-55-37	Amended	2016-06	03/14/2016
815-15-55-39	Amended	2016-06	03/14/2016
815-15-55-43	Amended	2016-06	03/14/2016
815-15-55-45	Amended	2016-06	03/14/2016
815-15-55-47	Amended	2016-06	03/14/2016
815-15-55-124	Amended	2016-06	03/14/2016
815-15-65-3	Added	2016-06	03/14/2016

The amendments in this Update were adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board.

Members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Daryl E. Buck
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

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. Topic 815 requires that embedded derivatives be separated from the host contract and accounted for separately as derivatives if the three criteria in paragraph 815-15-25-1 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. There is specific guidance in paragraph 815-15-25-40 through 25-43 for assessing whether call (put) options that can accelerate the repayment of principal on a debt instrument meet that criterion.

BC3. The guidance in paragraph 815-15-25-40 states that a call (put) option is considered to be clearly and closely related to a debt instrument, unless the debt involves a substantial premium or discount and the call (put) option is only contingently exercisable (provided the call (put) option has met other requirements for interest-rate related underlyings, in accordance with paragraph 815-15-25-26). For contingently exercisable call (put) options to be considered clearly and closely related, paragraph 815-15-25-41 states that they can be indexed only to interest rates or credit risk, not some extraneous event or factor. The guidance raised interpretative questions that the DIG tried to clarify through implementation guidance in a four-step decision sequence applicable to all call (put) options. The four-step decision sequence requires an entity to consider whether (a) the payoff is adjusted on the basis of changes in an index, (b) the payoff is indexed to an underlying other than interest rates or credit risk, (c) the debt involves a substantial premium or discount, and (d) the call (put) option is contingently exercisable.

BC4. Questions emerged about how the four-step decision sequence interacts with the original guidance for assessing contingently exercisable embedded call (put) options in debt instruments. Two divergent approaches developed in practice. The first approach only requires an analysis of the four-step decision sequence in assessing whether contingent call (put) options are clearly and closely related to

the debt host. The second approach requires an assessment of whether the event that triggers the ability to exercise the call (put) option is indexed only to interest rates or credit risk, not some extraneous event or factor, in addition to the four-step decision sequence. Those two approaches, which resulted from different interpretations of the intent of the four-step decision sequence, may result in different conclusions about whether the embedded call (put) option is clearly and closely related to its debt host, and, thus, may result in different conclusions about which call (put) options should be bifurcated and accounted for separately as derivatives.

BC5. At its June 18, 2015 meeting, the Task Force reached a consensus-for-exposure on this Issue that an entity should apply only the first approach described in the previous paragraph. The Board subsequently ratified the consensus-for-exposure and on August 6, 2015, issued a proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments*, for public comment, with a comment period that ended on October 5, 2015. The Board received eight comment letters on the proposed Update. Overall, respondents supported the amendments in the proposed Update.

BC6. The Task Force considered the feedback received on the proposed Update at its November 12, 2015 meeting and reached a consensus. The Board subsequently ratified the consensus, resulting in issuance of this Update.

Scope

BC7. The Task Force reached a consensus that the amendments in this Update should apply to all reporting entities that are issuers of or investors in debt instruments (or hybrid financial instruments that are determined to have a debt host) with embedded call (put) options.

Assessment of Call (Put) Options in Debt Instruments

BC8. The Task Force reached a consensus that clarifies that the determination of whether the economic characteristics and risks of call (put) options are clearly and closely related to their debt hosts only requires an assessment of the four-step decision sequence. Consequently, for contingently exercisable call (put) options, an assessment of whether the event that triggers the ability to exercise a call (put) option is related to interest rates or credit risk is not required.

BC9. Some Task Force members expressed a preference for an alternative approach currently applied by some in practice that requires an additional assessment of whether the event that triggers the ability to exercise the call (put) option is indexed to interest rates or credit risk and not some extraneous event. To those Task Force members, this alternative better reflects the conceptual basis underlying the guidance that an entity should not be able to avoid the recognition

and measurement requirements of derivatives guidance by simply embedding a derivative instrument in a nonderivative financial instrument or other contract.

BC10. Some Task Force members believe that disregarding the nature of the contingent event triggering exercisability of a call (put) option could enable an entity to avoid derivative accounting through the creation of a hybrid instrument. Those Task Force members suggested an approach that would consider an assessment of whether the contingency trigger is indexed to an external observable index or price or an event unrelated to the entities, rather than an assessment of whether the contingency trigger is indexed to interest rates or credit risk and not some extraneous event or factor. To those Task Force members, external contingency triggers that are linked to extraneous factors (for example, commodity or stock price indexes) indicate that the call (put) option is not clearly and closely related to its debt host. The Task Force rejected that approach for the reasons described below.

BC11. The Task Force acknowledged that the amendments in this Update could result in situations in which the accounting for embedded call (put) options in debt instruments may be different from what would be required if there was a separate instrument with the same terms as the call (put) option. However, the Task Force concluded that the consensus adequately limits the circumstances in which those differences could arise and is consistent with the DIG's intent when it interpreted the original guidance on embedded derivatives with the four-step decision sequence. Because the four-step decision sequence requires an entity to evaluate whether a substantial discount or premium is involved, any significant change to the payoff would result in the call (put) option not being clearly and closely related to its debt host irrespective of whether the contingent event is related to interest rates or credit risk. This requirement adequately limits the opportunity for an entity to be able to avoid applying the recognition and measurement requirements of derivatives guidance to circumstances in which the instrument's payoff is not significantly adjusted.

BC12. As a result, the Task Force also concluded that an assessment of the contingent event itself may create complexity in financial reporting with limited benefit to financial statement users because it may require an entity to value an embedded derivative whose value typically is small or zero at inception and continues that complexity going forward for events that may have a low likelihood of occurring.

Transition

BC13. The Task Force reached a consensus that an entity should apply the amendments in this Update 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 had bifurcated an embedded derivative but is no longer required to do so as a result of applying the amendments in this Update, the

aggregate of the carrying amount of the debt host contract and the fair value of the previously bifurcated embedded derivative will become the carrying amount of the debt instrument at the date of adoption. A premium or discount may result when combining the carrying amount of the debt host contract and the fair value of the previously bifurcated embedded derivative at the date of adoption. The Task Force decided that the premium or discount that results from the application of the amendments in this Update should not affect the entity's assessment of whether the call (put) option is clearly and closely related to the debt instrument. That is, the Task Force decided that for the purpose of the embedded derivative analysis, upon adoption, an entity should consider the economic characteristics and risks of the host contract and the call (put) option as they existed at the date of initial recognition of the instrument (upon issuance or acquisition).

BC14. The Task Force also reached a consensus that if an entity is no longer required to bifurcate an embedded derivative as a result of applying the amendments in this Update, the entity will have a one-time option, as of the beginning of the fiscal year for which the amendments are effective, to irrevocably elect to measure that debt instrument in its entirety at fair value with changes in fair value recognized in earnings. That option is available for instruments within the scope of paragraphs 825-10-15-4 through 15-5. For those instruments for which the entity elects fair value, the effects of initially complying with the amendments in this Update as of the effective date should be reported as a cumulative-effect adjustment directly to retained earnings as of the beginning of the fiscal year in which the amendments are adopted. The entity should elect fair value on an instrument-by-instrument basis.

BC15. 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 DIG in Statement 133 Implementation Issue K5, "Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues."

Effective Date

BC16. The Task Force decided that the amendments in this Update should be effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For entities other than public business entities, the amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. The Task Force decided that early application is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

Benefits and Costs

BC17. 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.

BC18. The Task Force does not anticipate that entities will incur significant costs as a result of the amendments resulting from this Update. The amendments provide the benefit of clarifying how to apply guidance that already exists within GAAP, thereby promoting consistency. The Task Force acknowledges that some reporting entities that applied existing guidance under an alternative interpretation may incur incremental costs at the time of initial adoption of the amendments. However, the Task Force expects that such incremental costs will not recur in subsequent reporting periods and that those entities will have reduced costs in future periods as a result of no longer being required to bifurcate certain embedded derivatives.

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 (Taxonomy). Those changes, which will be incorporated into the proposed 2017 Taxonomy, are available for public comment through ASU Taxonomy Changes provided at www.fasb.org, and finalized as part of the annual release process.