

Contingent Option Bifurcation Clarified

On March 14, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-06, *Derivatives and Hedging (Topic 815) Contingent Put and Call Options in Debt Instruments*. The ASU eliminates diversity in practice in assessing contingent put and call options embedded within certain debt instruments. The various interpretations of existing guidance led to different conclusions about bifurcation of an embedded derivative. This ASU does not change the criteria for determining when bifurcation of an embedded call (put) option in a debt instrument is required; it merely clarifies the steps required when assessing the “clearly and closely” related criteria. The ASU maintains the Derivative Implementation Group’s (DIG) four-step decision sequence and does not require an additional assessment of the event that triggers the ability to exercise the call (put) option. The clarification reduces the complexity of the process and may reduce the number of instruments requiring bifurcation.

Background

Accounting for complex financial instruments is challenging, especially when they contain embedded features with exercise contingencies. Embedded call (put) options are present in many debt instruments, including convertible bridge financing arrangements used by many pre-IPO and early-stage companies. In many cases, the embedded contingent put or call feature is directly related to a potential change in the issuer’s credit standing. Other events that may trigger the contingency include change in control or change in the issuer’s capital structure.

Under Topic 815, *Derivatives and Hedging*, instruments containing embedded derivatives must be assessed to determine whether they should be accounted for separately from the host contract. These embedded derivatives may have contingent features (based on one or more underlyings) that could modify some or all of the cash flows or other exchanges otherwise required by the host contract.

Embedded derivatives must be separated from the host and accounted for as derivatives if these criteria are met:

- The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host
- The instrument is not measured at fair value under other applicable generally accepted accounting principles with changes in fair value reported in earnings
- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative

Specific guidance for determining whether an embedded derivative’s economic characteristics and risks are clearly and closely related to the host contract’s economic characteristics and risks includes:

- Call (put) options that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to the debt instrument, unless both of these conditions exist:
 - The debt involves a substantial premium or discount, *e.g.*, zero-coupon bonds
 - The call (put) option is only contingently exercisable
- For contingently exercisable call (put) options to be considered clearly and closely related, they may be indexed only to interest rates or credit risk

In 1999, DIG issued additional guidance, creating a four-step decision sequence to assess whether puts and calls that can accelerate the settlement of debt instruments should be considered clearly and closely related to the debt host.

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- **Step 1:** Is the settlement amount adjusted based on changes in an index? If yes, continue to Step 2; if no, continue to Step 3.
- **Step 2:** Is the payoff indexed to an underlying factor other than interest rates or credit risk? If yes, the embedded feature is not clearly and closely related to the debt host contract, and no further analysis is required. If no, go to Steps 3 and 4.
- **Step 3:** Does the debt involve a substantial premium or discount? If yes, continue to Step 4. If no, further analysis is required if the embedded derivative's **only** underlying is interest-rate related, *e.g.*, an interest rate cap or an interest rate collar, that alters net interest payments otherwise paid or received on an interest-bearing host contract to determine whether the call (put) option is clearly and closely related to the debt host contract. The analysis should be conducted as follows:
 - The interest-rate-related embedded derivative is considered to be clearly and closely related to the host contract unless either of the following conditions exists:
 - The hybrid instrument can contractually be settled in such a way that the investor would not recover substantially all of its initial recorded investment
 - The embedded derivative meets both of these conditions (the "double-double test"):
 - There is a possible future interest rate scenario, even if remote, under which the embedded derivative would at least double the investor's initial rate of return on the host contract
 - If the investor's initial rate of return on the host contract would be doubled as discussed above, the embedded derivative also would result in a rate of return at least double the then-current market return for a contract with the same terms as the host contract and with a similar credit quality to the issuer inception
- **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 no, further analysis is required to determine whether the call (put) option is clearly and closely related to the debt host contract as noted in Step 3.

The diversity in practice arose over confusion about whether the referenced index refers to the payoff or the contingent event. While the amount of the payout may not be affected by the contingent event, the value of the overall instrument could be. Some believe the assessment of whether a put or call option is clearly and closely related to its debt host only requires an analysis of the four-step decision sequence, which includes an assessment of whether the payoff of the debt instrument is indexed only to interest rates or credit risk. Others believe they must use the four-step decision sequence and also assess whether the contingently exercisable call (put) is indexed only to interest rates or credit risk, rather than some extraneous event or factor. 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 ASU was issued to resolve the diversity in practice by clarifying that the assessment of whether a contingent put or call option is clearly and closely related to the debt host only requires an analysis of the four-step decision sequence.

An entity would not need to separately assess whether the contingent feature is only indexed to interest rates or the entity's credit risk. This approach is illustrated in the example below.

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Example – Updated bifurcation analysis

Facts: Bond issued at par for \$100. Call option at \$107 if price of gold is greater than \$X

Step 1: Is the settlement amount adjusted based on changes in an index?

No – The amount is fixed at \$107. The amount paid is not automatically adjusted to reflect changes in an index (price of gold) even though the contingent event that permits the issuer to exercise the call is indexed to the price of gold.

Step 3: Substantial premium or discount?

No – There is less than 10 percent difference. Assessment under the double-double test is not required since this instrument does not have a dual underlying.

Conclusion: *The call option is clearly and closely related to debt host; do not bifurcate.*

Effective Date & Transition

The amendments would be applied using a modified retrospective transition method. If an entity had bifurcated an embedded derivative but is no longer required to under this ASU, the carrying amount of the debt host contract and fair value of the previously bifurcated embedded derivative would become the carrying amount of the debt instrument at the date of adoption.

Entities no longer required to bifurcate an embedded derivative would have a one-time option to elect to measure the debt instrument in its entirety at fair value with changes in fair value recognized in earnings. The election would be on an instrument-by-instrument basis, and the effect would be reported as cumulative effect adjustment as of the beginning of the period of adoption.

For public business entities, the ASU is effective for fiscal periods—and interim periods within those fiscal periods—beginning after December 15, 2016. For all other entities, the ASU is effective for annual periods beginning after December 15, 2017, and interim periods within fiscal periods beginning after December 15, 2018. Early adoption is permitted.

For more information, contact your BKD advisor.