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Heads Up

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Three-Leaf Clover

FASB Issues ASUs in Response to EITF Consensuses

by Chris Cryderman, Mat Lorie, Inderjeet Singh, Mark Bolton, and Stephen McKinney, Deloitte & Touche LLP

Introduction

In response to consensuses reached by the Emerging Issues Task Force (EITF), the FASB has issued the following three Accounting Standards Updates (ASUs):

- *Recognition of Breakage for Certain Prepaid Stored-Value Products* (ASU 2016-04).
- *Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships* (ASU 2016-05).
- *Contingent Put and Call Options in Debt Instruments* (ASU 2016-06).

This *Heads Up* discusses each ASU's background, key provisions, effective date, and transition requirements.

Prepaid Stored-Value Products (ASU 2016-04)

Background

Entities may sell prepaid stored-value products in physical and digital forms that can be redeemed by the holder to purchase goods or services. When an entity sells a prepaid stored-value product, it recognizes a liability to the product holder. As the holder redeems the prepaid stored-value product, the entity reduces its liability to the holder and settles its liability to the merchant that provided the goods or services. For various reasons, product holders may not use any or a portion of the product's prepaid value (commonly referred to as "breakage"). There is diversity in practice related to when an entity can derecognize the liability to the product holder as a result of breakage.

Key Provisions

ASU 2016-04 amends the guidance on extinguishing financial liabilities for certain prepaid stored-value products (see the discussion of the ASU's scope below). If an entity selling prepaid stored-value products expects to be entitled to a breakage amount (i.e., an amount that will not be redeemed), the entity will recognize the effects of the expected breakage "in proportion to the pattern of rights expected to be exercised" by the product holder to the extent that it is probable that a significant reversal of the breakage amount will not subsequently occur. That is, an entity would not recognize breakage immediately but rather proportionally as the prepaid stored-value product is being redeemed.

Otherwise, the expected breakage would be recognized when the likelihood becomes remote that the holder will exercise its remaining rights.

Entities are required to reassess their estimate of breakage each reporting period. Any change in this estimate would be accounted for as a change in an accounting estimate.[1] An entity that recognizes breakage is required to disclose the "methodology used to recognize breakage and significant judgments made in applying the breakage methodology." Further, prepaid stored-value products within the scope of the ASU are excluded from the disclosure requirements in ASC 825[2] for financial liabilities.

Editor's Note: The derecognition amendments in ASU 2016-04 are consistent with the views expressed by the SEC staff and the method of accounting for breakage described in ASC 606,[3] including the "constraint" under which an entity recognizes the effects of the expected breakage to the extent that it is probable that a significant reversal of breakage will not subsequently occur. Entities may consider ASC 606-10-32-12, which lists factors that could increase the likelihood or magnitude of a subsequent reversal.

Scope

Prepaid stored-value products within the scope of the ASU are those that are "commonly accepted as payment for goods or services" except for products that are:

- Within the scope of other U.S. GAAP topics (e.g., casino gaming chips[4] or revenue transactions).
- Part of customer loyalty programs.
- Subject to unclaimed property laws.
- Solely redeemable by the product holder for cash (however, a product that can be redeemed for cash and goods or services would be within the scope of the ASU).
- Attached to a segregated bank account (i.e., a customer deposit account).

Examples of products within the scope of the ASU include traveler's checks, telecommunication cards, and money orders. Products not within the scope of the ASU include bearer bonds, nonrecourse debt, and trade payables.

Editor's Note: The scope of ASU 2016-04 excludes transactions that are accounted for under other U.S. GAAP topics, including revenue transactions. Prepaid stored-value products that are only redeemable from the issuer would generally be accounted for as a revenue transaction (from the issuer's perspective). It is our understanding that prepaid stored-value products that can be redeemed for goods or services from both the issuer and third-party merchants are within the scope of the ASU (from the issuer's perspective). For example, a prepaid stored-value product issuer may have corporate-owned locations as well as franchisee-owned locations. If a prepaid stored-value product can be used at both corporate- and franchisee-owned locations, the products would be within the scope of the ASU under the issuer's accounting.

[1] See ASC 250-10-45-17 through 45-20.

[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the FASB Accounting Standards Codification."

[3] See ASC 606-10-55-46 through 55-49.

[4] See ASC 924-405.

Transition and Effective Date

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, it is effective for annual periods beginning after December 15, 2018, and interim periods beginning after December 15, 2019. Early adoption is permitted, including adoption before the effective date of ASC 606. A reporting entity can apply the guidance by using either (1) a modified retrospective transition approach by recording a cumulative-effect adjustment to retained earnings as of the beginning of the annual period of adoption or (2) a full retrospective transition approach.

Example — Recognition of Breakage When an Amount of Breakage Is Expected

Company A sells a prepaid stored-value gift card within the scope of the ASU for $1,000 that can be used at third-party merchants and recognizes a liability for that amount to the card holder. On the basis of its historical experience with similar cards and its assessment of whether a significant revenue reversal could subsequently occur, A expects to be entitled to breakage of $200 (i.e., A expects that its liability of $1,000 will be settled for $800). Under the ASU, A would recognize breakage in proportion to the amount being redeemed (i.e., $200 of breakage would be recognized proportionally as the $800 is redeemed). As a result, A's liability will be further reduced by the breakage amount equaling 25 percent of the gift card amount being redeemed. For example, if the card holder used $40 of the gift card balance, $10 of breakage would be recorded, decreasing the gift card liability by $50. Assuming that A's estimate of breakage was unchanged, its liability would be settled when $800 of the gift card was used.

Derivative Contract Novations (ASU 2016-05)

Background

A derivative novation occurs when one party to the derivative contract assigns its rights and obligations to a new party (i.e., legally replaces itself with another party). Approval for the novation is typically required of the existing derivative counterparty. After the novation, the entity that was replaced by the new party no longer has any rights or obligations under the contract.

Derivative novations can occur for various reasons, including the following:

- As a result of a financial institution merger, to designate the surviving entity as the new counterparty.
- As a vehicle for exiting a line of business or moving risk exposures between different legal entities of the same parent company.
- To satisfy laws or regulatory requirements (e.g., as a means of complying with requirements to use central derivative clearing counterparties).

Under ASC 815, an entity must discontinue a hedging relationship if (1) the hedging derivative instrument expires or is sold, terminated, or exercised or (2) it wishes to change a critical term of the hedging relationship. ASC 815 does not, however, explicitly address how a novation of a hedging derivative affects a hedging relationship, and this ambiguity has resulted in inconsistent application in practice. ASU 2016-05 clarifies whether a change in the hedging derivative's counterparty should, in and of itself, trigger discontinuation of a hedging relationship (i.e., require the entity to dedesignate the hedge).

Editor's Note: In a May 2012 letter to the International Swaps and Derivatives Association and in a speech at the 2014 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff gave examples of situations in which it would not object to the continuation of an existing hedging relationship after a novation of the hedging derivative. The examples were intended to address concerns about the ramifications of then-recent legislation and rulemaking requiring the central clearing of certain derivative transactions and to limit diversity in practice. ASU 2016-05 shifts this paradigm; thus, an entity will now assume that a novation, by itself, will not force it to unwind its hedge instead of assuming that the hedge must be unwound unless the novation qualifies for a specified exception.

Key Provisions

ASU 2016-05 clarifies that "a change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, **in and of itself**, be considered a termination of the derivative instrument" (emphasis added) or "a change in a critical term of the hedging relationship." As long as all other hedge accounting criteria in ASC 815 are met, a hedging relationship in which the hedging derivative instrument is novated would not be discontinued or require redesignation. This clarification applies to both cash flow and fair value hedging relationships.

Editor's Note: The Basis for Conclusions of ASU 2016-05 states that "a reporting entity always is required to assess the creditworthiness of the derivative instrument counterparty in a hedging relationship (both in the normal course of the hedging relationship and upon a novation)." Although an entity would not be required to discontinue the hedging relationship solely as a result of a change in counterparty, the entity would need to consider the counterparty's creditworthiness. If the new counterparty's creditworthiness differs significantly from that of the original counterparty, the hedging relationship may no longer be a highly effective hedge, which would trigger discontinuation of the hedged relationship.

Effective Date and Transition

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. An entity would apply the guidance prospectively unless it elects modified retrospective transition. Early adoption is permitted, including in an interim period.

Prospective Approach

Under the prospective approach, an entity would apply the amendments only to hedging relationships in which a counterparty to the hedging derivative is changed after the date the reporting entity adopted ASU 2016-05.

Modified Retrospective Approach

If elected, the modified retrospective approach will apply to derivative instruments that satisfy **all** of the following conditions:

- "The derivative instrument was outstanding during all or a portion of the periods presented in the financial statements."

- “The derivative instrument was previously designated as a hedging instrument in a hedging relationship.”
- “The hedging relationship was dedesignated solely due to a novation of the derivative instrument, and all other hedge accounting criteria [in ASC 815] would have otherwise continued to be met.”[5]

For such hedging relationships, an entity would remove from the financial statements the effect of the hedge dedesignation that resulted from the novation for each period presented. The entity also would adjust beginning retained earnings to reflect the cumulative effect on the financial statements of derivatives that (1) meet the requirements above and (2) were dedesignated from hedging relationships as a result of novations that occurred before the beginning of the earliest period presented.

> **Editor’s Note:** To apply the modified retrospective approach, an entity is required to assess hedge effectiveness and measure ineffectiveness as required by the original hedge documentation under ASC 815 for all periods between (1) the date on which the hedging relationship was dedesignated solely because of a novation and (2) the date on which the entity adopts ASU 2016-05.

Disclosures

Under either transition approach, an entity must provide the disclosures required by ASC 250-10-50-1(a) and 50-2 about the nature of and reason for the change in accounting principle, as applicable, in the period it adopts the ASU. An entity electing the modified retrospective approach must also provide the disclosures required by ASC 250-10-50-1(b)(1) and 50-1(b)(3) about the amounts retrospectively adjusted and the cumulative effect on retained earnings, as applicable.

Contingent Put and Call Options in Debt Instruments (ASU 2016-06)

Background

To determine how to account for debt instruments with embedded features, including contingent put and call options, an entity is required to assess whether the embedded derivatives must be bifurcated from the host contract and accounted for separately. Part of this assessment consists of evaluating whether the embedded derivative features are clearly and closely related to the debt host. Under existing guidance, for contingently exercisable options to be considered clearly and closely related to a debt host, they must be indexed only to interest rates or credit risk.

ASU 2016-06 addresses inconsistent interpretations of whether an event that triggers an entity’s ability to exercise the embedded contingent option must be indexed to interest rates or credit risk for that option to qualify as clearly and closely related. Diversity in practice has developed because the existing four-step decision sequence in ASC 815-15-25-42[6] focuses only on whether the payoff was indexed to something other than an interest rate or credit risk. As a result, entities have been uncertain whether they should (1) determine whether the embedded features are clearly and closely related to the debt host solely on the basis of the four-step decision sequence or (2) first apply the four-step decision sequence and then also evaluate whether the event triggering the exerciseability of the contingent put or call option is indexed only to an interest rate or credit risk (and not some extraneous event or factor).

[5] Such criteria would include those that require assessment of the possibility of a default by the counterparty to the hedging derivative. See ASC 815-20-35-14 through 35-18.

[6] The four-step decision sequence is implementation guidance that was originally developed by the FASB’s Derivatives Implementation Group. See the appendix for more information.

Key Provisions

The ASU clarifies that in assessing whether an embedded contingent put or call option is clearly and closely related to the debt host, an entity is required to perform only the four-step decision sequence in ASC 815-15-25-42 as amended by the ASU (see the appendix). The entity does not have to separately assess whether the event that triggers its ability to exercise the contingent option is itself indexed only to interest rates or credit risk.

Example — Contingent Put Option Embedded in a Note

Entity A issues a 10-year note at par, which becomes puttable to the issuer at 105 percent of par plus accrued interest if the S&P 500 Index exceeds 2,200.

Entity A must apply the four-step decision sequence in ASC 815-15-25-42, as amended, as follows to evaluate whether the embedded put option is clearly and closely related to the debt host (see the appendix for more information about the four-step decision sequence):

- *Step 1* — Is the amount paid upon settlement adjusted on the basis of the changes in an index?

  No. The exercise of the contingency is based on the S&P 500 Index. However, the payoff upon settlement is not "adjusted based on changes in an index." The payoff amount is fixed at 105 percent of par, plus accrued interest. Entity A would proceed to Step 3.
- *Step 2* — Is the payoff indexed to an underlying other than interest rates or credit risk?

  This step is not applicable. As discussed in Step 1, the payoff is fixed.
- *Step 3* — Does the debt involve a substantial premium or discount?

  No. The debt is issued at par and puttable for a premium of 5 percent, which is not substantial. Also, the guidance in paragraph ASC 815-15-25-26 is not applicable because the movement in the S&P 500 Index is considered a second underlying; therefore, the embedded put is not one in which "the only underlying is an interest rate or interest rate index."
- *Step 4* — Does a contingently exercisable call (put) option accelerate the repayment of the contractual principal amount?

  This step is not applicable. Analysis is not required because the answer to the question in Step 3 is no (i.e., no substantial discount or premium).

The embedded put option is *clearly and closely* related to the debt host and therefore is not required to be bifurcated. Entity A is not required to separately assess whether the event (i.e., the movement in the S&P 500 Index) that triggers the noteholder's ability to exercise the contingent option is itself indexed only to interest rates or credit risk.

Effective Date and Transition

For public business entities, the ASU is effective for financial statements issued for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. For all other entities, it is effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods beginning after December 15, 2018. An entity can early adopt the ASU, including in an interim period; however, if it early adopts in an interim period, it should reflect any adjustment as of the beginning of the fiscal year that includes the interim period.

An entity will apply a modified retrospective transition approach that requires it to use the four-step decision sequence to determine for existing debt instruments whether an embedded derivative is clearly and closely related to the debt host and to take into account the economic characteristics and risks of the host contract and the embedded derivative that existed on the date it issued or acquired the instrument.

If bifurcation of an embedded derivative is no longer required as a result of applying the ASU, the entity will determine the carrying amount of the debt instrument on the date of adoption as the aggregate of the carrying amount of the debt host contract and the fair value of the previously bifurcated embedded derivative. Any premium or discount resulting from such aggregation will not affect the entity's assessment of whether the call (put) option is clearly and closely related to the debt instrument. The entity will not make any cumulative-effect adjustments to beginning retained earnings.

An entity that is no longer required to bifurcate an embedded derivative from a debt instrument as a result of applying the guidance in the ASU also 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 and recognize changes in fair value in earnings. The effects of such an election would be reported as a cumulative-effect adjustment to the beginning retained earnings of the fiscal year of adoption. The entity should elect to apply the fair value option on an instrument-by-instrument basis.

Appendix — Four-Step Decision Sequence

ASC 815-15-25-42 (as amended by ASU 2016-06) provides the following four-step decision sequence for determining whether call (put) options that can accelerate the settlement of debt instruments would 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? 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.
>
> Step 3: Does the debt involve a substantial premium or discount? If yes, continue to Step 4. If no, further analysis of the contract under [ASC] 815-15-25-26 is required, if 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, further analysis of the contract under [ASC] 815-15-25-26 is required, if applicable.

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