



Project

Leases

Topic

Embedded derivatives

Introduction and summary of staff recommendations

1. This paper discusses the accounting for embedded derivatives that can arise in lease contracts. It addresses accounting by both lessees and lessors.
2. More specifically, it discusses whether entities should be required to assess whether their lease contracts include embedded derivatives that should be bifurcated and accounted for in accordance with the guidance on financial instruments.
3. There is a separate agenda paper discussing the consequences of including the classification and measurement of the lessor's right to receive lease payments within the scope of the guidance on financial instruments, which will be presented at a future meeting. If lease receivables were included in the scope of the guidance on financial instruments, separation of embedded derivatives from the lease receivable would not be allowed in accordance with IFRS 9 *Financial Instruments* and the classification and measurement requirements of IFRS 9 would be applied to the entire hybrid instrument. As a result, the existence of an embedded derivative would probably require the entire lease receivable to be measured at fair value when applying IFRSs. Because US GAAP requires bifurcation of embedded derivatives in all financial instruments and allows amortised cost measurement for some financial instruments, in many cases the lease assets and liabilities could be measured at

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amortised cost, ie this would lead to a different outcome than if IFRS guidance on financial instruments were applied.

4. This paper assumes that lease receivables are outside the scope of financial instruments guidance and only considers the possible interaction with embedded derivative requirements in that guidance.
5. Some of the staff recommendations in this paper depend on the boards' decision on the reassessment of lease payments linked to an index or a rate.
6. The majority of the staff think that, regardless of whether the boards decide to reassess lease payments linked to an index or a rate, entities should be required to assess whether their lease contracts include embedded derivatives that should be accounted for in accordance with the guidance on financial instruments.
7. However, the view of a minority of the staff depends on whether the boards decide to reassess lease payments linked to an index or a rate.
 - (a) If the boards decide to require reassessment to update the rate or index, these staff think that all host lease contracts should be excluded from the scope of embedded derivatives guidance and that only the recognition and measurement requirements in the final leases standard should be applied.
 - (b) If the boards decide not to require reassessment to update the rate/index, consistent with the majority of staff, these staff recommend continuing to require embedded derivatives included in lease contracts to be assessed and accounted for in accordance with the financial instruments guidance.

Proposals and feedback received

8. The *Leases* exposure draft (ED) did not provide guidance on embedded derivatives in lease contracts and nor did it ask a question about it. The *Leases* Discussion Paper made reference to existing requirements:

In some situations, contingent rental arrangements may qualify as embedded derivatives that are required to be separated from the

host lease contract and accounted for as a derivative. The proposals in this discussion paper would not change this requirement. (paragraph 7.4 of *Leases* DP)

9. Existing guidance on embedded derivatives in lease contracts is included in Appendix A of this paper for IFRSs and Appendix B for US GAAP.
10. A handful of comment letters discussed the topic. In those letters, there was support for keeping the existing guidance. For example:

The source of variability in payments in a lease contract may be due to an embedded derivative. We agree with retaining the current guidance that requires embedded derivatives that are not closely related to the lease contract to be bifurcated and accounted for separately. If the embedded derivative is closely related to the lease contract and thus not bifurcated, then it would be subject to the contingent payments guidance within the proposals in the ED (CL # 364)

11. Some respondents asked for clarification of the requirements to assess lease contracts for embedded derivatives. They thought that the ED's lack of guidance on the subject might be perceived as a change in current practice.
12. Finally, some respondents were concerned about possible double-counting of variable lease payments if both embedded derivative guidance *and* the lease accounting measurement proposals are applied (eg variable lease payments that depend on a rate or an index).
13. Users and private companies did not give specific feedback on embedded derivatives in lease contracts.

Staff analysis

Background

14. Both IFRSs (IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9) and US GAAP (ASC Topic 815-15 *Derivatives and Hedging—Embedded Derivatives*), while excluding rights and obligations in the current lease requirements from the classification and measurement requirements of the financial instrument standards, require an assessment of whether lease contracts contain embedded derivatives. An embedded derivative in a host lease contract must be measured separately if three criteria are met:

- (a) the entire hybrid contract is not measured at fair value through profit or loss;
 - (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and
 - (c) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host.
15. Detailed requirements in IFRS and US GAAP in relation to embedded derivatives are included in Appendix A and B.
16. Examples of lease contracts that may contain embedded derivatives include leases with payments that:
- (a) consist of a fixed amount plus an annual increase equal to a multiple of the inflation index.
 - (b) are linked to a commodity price.
 - (c) are linked to a foreign exchange rate for a currency other than the functional currency of parties to the contract (there are other exceptions).
17. All of these examples refer to lease contracts that include variable lease payments that depend on an index or a rate. However, there are other sources of variability in leases contracts that may require assessment to determine whether an embedded derivative exists. These include:
- (a) residual value guarantees. Residual value guarantees (RVGs) may not meet the definition of a derivative in IFRSs and may instead be considered insurance contracts (because the risks are not financial only but also compensate for the condition of the underlying, see paragraph IG2 1.15 of IFRS 4 *Insurance Contracts*). Those that meet the definition of derivative, because they are linked to market prices only and not the underlying, would likely be considered to be closely related and as such would not be required to be separated. US GAAP specifically excludes RVGs from the scope of the derivatives

guidance, subject to certain conditions being met (paragraph 13 of ASC Section 815-10-15);

- (b) options to extend or terminate the lease and purchase options. Guidance on the accounting for options to extend or terminate the lease and purchase options would be included in the proposed leases standard and would unlikely be accounted for as embedded derivatives; and
 - (c) other variable lease payments. Variable lease payments that depend on sales are specifically excluded from embedded derivative accounting in both IFRS and US GAAP (see extracts from relevant guidance in Appendix A and B).
18. The following sections focus on variable lease payments that depend on an index or a rate. This is because the staff understand from feedback received through comment letters and in preparer workshops that these are the most common components of lease contracts that are assessed in accordance with current US GAAP and IFRS guidance on embedded derivatives.

Is an embedded derivatives assessment required?

19. The issue arises as to whether, when a lease contract contains an embedded derivative, an entity should:
- (a) apply only the recognition and measurement guidance in the final leases standard when accounting for all lease payments (ie current financial instrument requirements for the assessment of embedded derivatives in host lease contracts should be removed); or
 - (b) apply the recognition, classification and measurement requirements in the guidance on financial instruments when accounting for the components of a host lease contract that meet the definition of an embedded derivative that should be bifurcated.

Approach A—apply only the recognition and measurement guidance in the final leases standard

20. Under this approach, entities would refer only to guidance in the final leases standard for the recognition and measurement of lease payments. Embedded derivatives contained in a host lease contract would be excluded from the scope of the embedded derivatives accounting required in the guidance on financial instruments.
21. Proponents of this approach argue that:
 - (a) requiring reassessment of variable lease payments that are linked to a rate or an index achieves a similar ‘current measurement’ objective as applying the measurement requirements for embedded derivatives. The benefits of moving from this current measurement basis to fair value do not exceed the costs of assessing all lease contracts for embedded derivatives and measuring them separately. Embedded derivatives that need to be bifurcated typically arise only for payments linked to an index or a rate and thus measurement of other variable lease payments is irrelevant.
 - (b) the leases standard should provide ‘standalone guidance’ on which lease payments should be recognised in the initial measurement of the right-of-use asset and the liability to make lease payments and how these payments should be initially and subsequently measured.
 - (c) it is consistent with the boards’ tentative decision not to require fair value measurement of variable lease payments.
 - (d) it avoids comparability concerns (for example, in a lease payment indexed to one and a half times the inflation rate, the index would need to be separated and measured at fair value as an embedded derivative, but a lease payment indexed simply to the inflation index (with no multiple) may be accounted for as a lease payment and measured using a spot rate).

- (e) it avoids applying the guidance on embedded derivatives, which is generally rule-based and includes lease payments that some preparers think are clearly and closely related to the host contract (for example, commodity-linked lease payments relating to equipment used by extractive industries).
- (f) a converged accounting answer is achieved, noting the differences that exist in the guidance on embedded derivatives in current IFRSs and US GAAP. Approach A is a simpler approach, avoiding the complexity of requiring assessment of all lease contracts for embedded derivatives.

Approach B—continue to apply the guidance on financial instruments to assess and account for embedded derivatives

- 22. Under this approach, entities would continue to assess whether host lease contracts contain embedded derivatives. If the lease contract contains embedded derivatives, the guidance on financial instruments should be applied to determine whether the derivative should be accounted for separately (ie whether or not they are clearly and closely related).
- 23. Proponents of this approach argue that it:
 - (a) ensures that risks related to these embedded derivatives are reflected by initial and subsequent measurement at fair value, providing users with timely information.
 - (b) avoids structuring opportunities that would arise if guidance on embedded derivatives were to be removed (for example embedding derivative contracts that are not closely related into lease host contracts). This issue was the genesis of the literature on embedded derivatives.
 - (c) creates limited additional cost for preparers because it is consistent with the current requirements in IFRS and US GAAP.

- (d) recognises that, even if the boards decide to reassess payments that depend on an index or a rate, the measurement of those payments, although it would reflect current market conditions, would still not be at fair value. For example, IAS 39 AG 8 today requires adjustment of the carrying amount of a financial asset or financial liability to reflect actual and revised estimated cash flows. However, the limitations of this approach result in embedded derivatives guidance still being applicable.
- Approach B would not lead to ‘plain vanilla’ terms included in lease contracts being accounted for as embedded derivatives (eg the ‘closely related’ notion separates economically related derivatives from structured derivatives such as those that include significant leverage).

Staff recommendations

24. The staff think that fair value measurement of assets and liabilities relating to lease contracts, including those components that may meet the definition of an embedded derivative, would provide the most useful information. However, the staff note that throughout deliberations on the project, the boards have discussed how to weigh up the benefits to users with the costs that would be incurred by preparers in providing this information.
25. This was reflected in the boards’ decision to use a spot rate when initially measuring lease payments that depend on a rate or an index and is likely to be a factor that will be considered by the boards when determining whether this spot rate should be updated in the subsequent measurement of liabilities for these lease payments. As a result, the recommendation of some of the staff on accounting for embedded derivatives in lease contracts depends on the boards’ tentative decision on reassessment of lease payments linked to an index or a rate.

26. If the boards decide to require reassessment of lease payments that are linked to an index or a rate when the rate or index changes, a minority of staff recommend not requiring entities to apply the requirements for accounting for embedded derivatives to lease payments. This is because subsequent measurement of the derivative elements of such contracts would be on a current measurement (although not fair value) basis, providing users with updated information about the risks in the lease assets and lease liabilities.
27. Those staff think that requiring bifurcation of embedded derivatives included within a host lease contract would increase the cost and complexity of accounting without providing sufficient benefit.
28. In addition, those staff have been persuaded by the evidence from current practice, which suggests that few index- and rate-linked payments in lease contracts are embedded derivatives that need to be bifurcated. However, the current guidance requires every lease contract to be assessed for embedded derivatives, which can be time-consuming and costly.
29. If the boards decide to not require the reassessment of lease payments that are linked to an index or a rate when that rate or index changes, those staff recommend continuing to require entities to apply the requirements for accounting for embedded derivatives to lease contracts. This is because the cost and complexity of accounting would be justified by the relevant information provided to the users about the changes in the risks embedded in the lease assets and liabilities.
30. However, the majority of staff recommend continuing to apply the guidance on embedded derivatives for lease contracts, regardless of the boards' decision on reassessment of variable lease payments that depend on an index or a rate. In the view of those members of staff, measuring those derivatives at fair value is the only way to make sure that users obtain timely information about the risks of those derivatives.

31. Those staff argue that even if variable lease payments are remeasured at each reporting period in accordance with the final leases standard, differences would exist between this remeasurement approach and the fair value measurement that would be required if embedded derivative accounting is applied. This might provide motivation to structure lease contracts to include embedded derivatives, which would not have to be measured at fair value through profit or loss.
32. They note that guidance on embedded derivatives and the closely related criteria were originally introduced to prevent abuse, and this risk is unchanged. In addition, they recognise that one of the reasons why there may be few embedded derivatives that are not separated today is exactly because of the current embedded derivative requirements.

Question for the boards

Some staff recommend retaining the requirement for assessment and bifurcation of embedded derivatives in lease contracts, but only if the boards decide not to require reassessment of variable lease payments that depend on an index or a rate.

Other staff recommend retaining the requirement for assessment and bifurcation of embedded derivatives in lease contracts regardless of whether the measurement of variable lease payments that depend on an index or a rate is reassessed.

What is the boards' view? Why?

Appendix A—IFRS guidance

A1. IFRS 9, paragraph 4.3.3 states:

If a hybrid contract contains a host that is not an asset within the scope of this IFRS, an embedded derivative shall be separated from the host and accounted for as a derivative under this IFRS if, and only if:

- a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);
- b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

A2. IAS 39 *Financial Instruments: Recognition and Measurement*, paragraph 9 defines a derivative as follows:

A financial instrument or other contract within the scope of IFRS 9 with all three of the following characteristics.

- (i) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, **provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’)**
- (ii) It requires no initial investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- (iii) It is settled at a future date. (emphasis added)

- A3. IFRS 9, paragraph B4.3.5 discusses when the embedded derivative is not closely related to the host contract:

The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 4.3.3(a)) in the following examples. In these examples, assuming the conditions in paragraph 4.3.3(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

- (a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.
- (b) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.
- (c) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (d) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (e) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:
- (i) the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract; or

(ii) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with IAS 32.

(f) Credit derivatives that are embedded in a host debt instrument and allow one party (the 'beneficiary') to transfer the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor') are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

A4. IFRS 9, paragraph B4.3.8 discusses when the embedded derivative is closely related to the host contract:

The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

(b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

(c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (eg a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because IAS 21 requires foreign currency gains and losses on monetary items to be recognised in profit or loss.

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

(e) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.

(f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.

(g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

(h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).

Appendix B—US GAAP guidance

B1. Paragraph 1 of Section 815-15-25 discussed when embedded derivatives need to be bifurcated:

An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

B2. Paragraph 83 of Section 815-10-15 defines the derivative as follows:

A derivative instrument is a financial instrument or other contract with all of the following characteristics:

- a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
 1. One or more underlyings
 2. One or more notional amounts or payment provisions or both.
- b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Net settlement. The contract can be settled net by any of the following means:
 1. Its terms implicitly or explicitly require or permit net settlement.
 2. It can readily be settled net by a means outside the contract.
 3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

- B3. Paragraph 61 of FAS 133 (in various places in the ASC), reflecting amendments as a result of ASU 2010-08, provides application guidance for assessment whether economic characteristics and risks of the embedded derivatives are closely related to the host contract:

61. The following guidance is relevant in deciding whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract.

a. *Interest rate indexes.* An embedded derivative in which the underlying is an interest rate or interest rate index and a host contract that is considered a debt instrument are considered to be clearly and closely related unless, as discussed in paragraph 13, the embedded derivative contains a provision that (1) permits any possibility whatsoever that the investor's (or 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 or (2) could under any possibility whatsoever at least double the investor's initial rate of return on the host contract and also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality. The requirement to separate the embedded derivative from the host contract applies to *both parties* to the hybrid instrument even though the above tests focus on the investor's net cash inflows. Plain-vanilla servicing rights, which involve an obligation to perform servicing and the right to receive fees for performing that servicing, do not contain an embedded derivative that would be separated from those servicing rights and accounted for as a derivative.

b. *Inflation-indexed interest payments.* The interest rate and the rate of inflation in the economic environment for the currency in which a debt instrument is denominated are considered to be clearly and closely related. Thus, non-leveraged inflation-indexed contracts (debt instruments, capitalized lease obligations, pension obligations, and so forth) would *not* have the inflation-related embedded derivative separated from the host contract.

c. *Credit-sensitive payments.* The creditworthiness of the debtor and the interest rate on a debt instrument are considered to be clearly and closely related. Thus, for debt instruments that have the interest rate reset in the event of (1) default (such as violation of a credit-risk-related covenant), (2) a change in the debtor's published credit rating, or (3) a change in the debtor's creditworthiness indicated by a change in its spread over Treasury bonds, the related embedded derivative would *not* be separated from the host contract.

d. *Calls and puts on debt instruments.* Call options (or 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 (1) the debt involves a substantial premium or discount (which is common with zero-coupon bonds) and (2) the put or call option is only contingently exercisable. 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 options (or 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 and would be separated from the host contract. In certain unusual situations, a put or call option may have been subsequently added to a debt instrument in a manner that causes the investor (creditor) to be exposed to performance risk (default risk) by different parties for the embedded option and the host debt instrument, respectively. In those unusual situations, the embedded option and the host debt instrument are *not* clearly and closely related.

e. *Calls and puts on equity instruments.* A put option that enables the holder to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is *not* clearly and closely related to that equity instrument. Thus, such a put option embedded in the equity instrument to which it relates should be separated from the host contract by the holder of the equity instrument. That put option also should be separated from the host contract by the issuer of the equity instrument except in those cases in which the put option is not considered to be a derivative instrument pursuant to paragraph 11(a) because it is classified in stockholders' equity. A purchased call option that enables the issuer of an equity instrument (such as common stock) to reacquire that equity instrument would not be considered to be a derivative instrument by the issuer of the equity instrument pursuant to paragraph 11(a). Thus, if the call option were embedded in the related equity instrument, it would not be separated from the host contract by the issuer. However, for the holder of the related equity instrument, the embedded written call option would *not* be considered to be clearly and closely related to the equity instrument and should be separated from the host contract.

f. *Floors, caps, and collars.* Floors or caps (or collars, which are combinations of caps and floors) on interest rates and the interest rate on a debt instrument are considered to be clearly and closely related, provided the cap is at or above the current market price (or rate) and the floor is at or below the current market price (or rate) at issuance of the instrument. Thus, the derivative embedded in a variable-rate debt instrument that has a floor on the interest rate (that is, the floor option) would not be separated from the host contract and accounted for separately even though, in a falling interest rate environment, the debt instrument may have a return to the investor that is a significant amount above the market return of a debt instrument without the floor provision (refer to paragraph 13(b)).

g. *Term-extending options.* An embedded derivative provision that either (1) unilaterally enables one party to extend significantly the remaining term to maturity or (2) automatically extends significantly the remaining term triggered by specific events or conditions is *not* clearly and closely related to the interest rate on a debt instrument unless the interest rate is concurrently reset to the approximate current market rate for the extended term and the debt instrument initially involved no significant discount. Thus, if there is no reset of interest rates, the embedded derivative must be separated from the host contract and accounted for as a derivative instrument. That is, a term-extending option cannot be used to circumvent the restriction in paragraph 61(a) regarding the investor's not recovering substantially all of its initial recorded investment.

h. *Equity-indexed interest payments.* The changes in fair value of an equity interest and the interest yield on a debt instrument are *not* clearly and closely related. Thus, an equity-related derivative embedded in an equity-indexed debt instrument (whether based on the price of a specific common stock or on an index that is based on a basket of equity instruments) must be separated from the host contract and accounted for as a derivative instrument.

i. *Commodity-indexed interest or principal payments.* The changes in fair value of a commodity (or other asset) and the interest yield on a debt instrument are *not* clearly and closely related. Thus, a commodity-related derivative embedded in a commodity-indexed debt instrument must be separated from the non-commodity host contract and accounted for as a derivative instrument.

j. Indexed rentals: (1) *Inflation-indexed rentals.* Rentals for the use of leased assets and adjustments for inflation on similar property are considered to be clearly and closely related. Thus, unless a significant leverage factor is involved, the inflation-related derivative embedded in an inflation-indexed lease contract would *not* be separated from the host contract. (2) *Contingent rentals based on related sales.* Lease contracts that include contingent rentals based on certain sales of the lessee would *not* have the contingent-rental-related embedded derivative separated from the host contract because, under paragraph 10(e)(3), a non-exchange-traded contract whose underlying is specified volumes of sales by one of the parties to the contract would not be subject to the requirements of this Statement. (3) *Contingent rentals based on a variable interest rate.* The obligation to make future payments for the use of leased assets and the adjustment of those payments to reflect changes in a variable-interest-rate index are considered to be clearly and closely related. Thus, lease contracts that include contingent rentals based on changes in the prime rate would *not* have the contingent-rental-related embedded derivative separated from the host contract.

k. *Convertible debt.* The changes in fair value of an equity interest and the interest rates on a debt instrument are not clearly and closely related. Thus, for a debt security that is convertible into a

specified number of shares of the debtor's common stock or another entity's common stock, the embedded derivative (that is, the conversion option) must be separated from the debt host contract and accounted for as a derivative instrument provided that the conversion option would, as a freestanding instrument, be a derivative instrument subject to the requirements of this Statement. (For example, if the common stock was not readily convertible to cash, a conversion option that requires purchase of the common stock would not be accounted for as a derivative.) That accounting applies only to the holder (investor) if the debt is convertible to the debtor's common stock because, under paragraph 11(a), a separate option with the same terms would not be considered to be a derivative for the issuer.

1. *Convertible preferred stock.* Because the changes in fair value of an equity interest and interest rates on a debt instrument are not clearly and closely related, the terms of the preferred stock (other than the conversion option) must be analysed to determine whether the preferred stock (and thus the potential host contract) is more akin to an equity instrument or a debt instrument. A typical cumulative fixed-rate preferred stock that has a mandatory redemption feature is more akin to debt, whereas cumulative participating perpetual preferred stock is more akin to an equity instrument. (*emphasis added*)