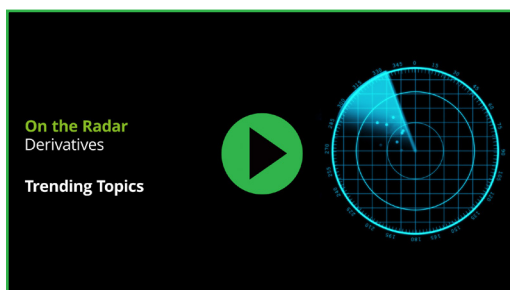




## On the Radar Derivatives

Although the guidance on accounting for derivatives has not changed significantly in recent years, derivative accounting continues to be one of the most complex areas of U.S. GAAP. ASC 815 prescribes the guidance on instruments and contracts that meet the definition of a derivative. Some instruments and contracts that meet this definition are eligible for a scope exception, while others that do *not* meet the definition of a derivative in their entirety must still be evaluated to determine whether they contain embedded derivatives that would be within the scope of ASC 815. In addition, some derivatives are designated in a qualified hedging relationship and eligible for specialized hedge accounting (see Deloitte’s Roadmap [Hedge Accounting](#) for further information on this topic).



# Financial Reporting Considerations

## What is a derivative?

In the simplest terms, a derivative is an instrument whose value depends on (or is derived from) the value of an underlying variable or variables, such as the prices of traded assets. Most derivatives are net-settled contracts that allow the holder to benefit from changes in the value of a referenced asset or other market variable while making a smaller initial investment than would be required to own that asset and experience similar gains and losses.

There are different types of derivative contracts, but the most common ones are forwards, futures, options, and swaps. When an entity enters into these types of contracts, it may be fairly obvious that such a contract meets the definition of a derivative. However, the accounting definition of a derivative sometimes encompasses other types of contracts that are not commonly thought of as derivatives, such as financial guarantees and contracts to purchase materials or power, or commodity contracts that require the physical delivery of assets that are readily convertible to cash.

In accordance with ASC 815-10-15-83, **all three** of the criteria below must be satisfied for a contract to meet the definition of a derivative:

<b>Underlying, notional amount, payment provision</b>	The contract contains both (1) “[o]ne or more underlyings” and (2) “[o]ne or more notional amounts or payment provisions or both.”
<b>Initial net investment</b>	“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.”
<b>Net settlement</b>	“The contract can be settled net by any of the following means: <ol style="list-style-type: none"><li>1. Its terms implicitly or explicitly require or permit net settlement.</li><li>2. It can readily be settled net by a means outside the contract.</li><li>3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.”</li></ol>

An entity should apply the guidance in ASC 815 when determining whether a specific contract meets the definition of a derivative.

In addition to providing the criteria required for a contract to be considered a derivative, ASC 815-10 includes a variety of scope exceptions. A contract that would otherwise meet the definition of a derivative may qualify for one of those exceptions, in which case it would be accounted for on the basis of other applicable U.S. GAAP. Some of the more frequently used scope exceptions apply to (1) certain contracts involving an entity's own equity and (2) certain contracts that are consistent with an entity's normal course of business (the normal purchases and normal sales scope exception).

**A contract that would otherwise meet the definition of a derivative in ASC 815 but qualifies for a scope exception does not require classification and measurement as a derivative asset or liability. An entity should consider whether a contract meets any of the available scope exceptions before applying the guidance in ASC 815 on classification, recognition, and measurement of derivatives. For more information, see Deloitte's Roadmap [Derivatives](#).**

## What is an embedded derivative?

An instrument that does not meet the definition of a derivative in its entirety may contain contractual terms or features that affect the cash flows, values, or other exchanges required by the terms of the instrument in a manner similar to a derivative. Such terms or features are “embedded” in the overall arrangement or contract and are referred to as “embedded derivatives.”

Under ASC 815-15-25-1, an entity is required to bifurcate and separately account for a feature embedded within another contract (the host contract) if **all three** of the conditions shown below are met.

<b>Not clearly and closely related</b>	“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>Hybrid instrument not measured at fair value on a recurring basis</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.”
<b>Meets the definition of a derivative</b>	“A separate [freestanding] instrument with the same terms as the embedded derivative” would meet the definition of a derivative and would not qualify for a derivative scope exception.

Embedded derivatives are commonly identified in debt and equity instruments, although it is possible for them to exist in other contracts (e.g., leases, service arrangements, insurance contracts). For example, if options allow the holder of a debt or equity instrument to either convert its instrument into shares of the issuer’s equity or redeem its instrument for cash, such options are embedded derivatives in the debt or equity instrument, respectively.

The determination of whether an embedded feature in a debt or equity host meets the definition of a derivative often depends on whether one of the criteria related to net settlement is met. For instance, equity in an entity that is not publicly traded is generally not readily convertible to cash, so redemption or conversion options for a nonpublic entity would generally not meet the definition of a derivative. When assessing whether an embedded feature, if freestanding, would meet the definition of a derivative, an entity should closely evaluate whether the feature provides for net settlement.

**If an entity determines that one of the criteria for bifurcation of an embedded derivative is not met, the embedded feature does not need to be bifurcated and further analysis of the remaining criteria is not necessary. For more information, see Deloitte’s Roadmap [Derivatives](#).**

## How are derivatives measured and recognized?

A key underlying principle of ASC 815 is that derivatives represent either assets or liabilities in the statement of financial position, and those assets or liabilities should be measured initially and subsequently at fair value by applying the concepts of ASC 820 (see Deloitte's Roadmap [Fair Value Measurements and Disclosures \(Including the Fair Value Option\)](#) for more guidance). The accounting for changes in the fair of a derivative instrument depends on whether it has been designated as a hedging instrument in a qualified hedging relationship. Derivatives that are designated as a hedging instrument in a qualified hedging relationship are eligible for specialized hedge accounting (see Deloitte's Roadmap [Hedge Accounting](#) for more information). Other than in limited scenarios, the gain or loss on a derivative instrument that has *not* been designated as a hedging instrument should be recognized in current-period earnings.

In addition, if any feature of an instrument has been identified and bifurcated as an embedded derivative, the entity should apply the accounting in ASC 815 related to measurement and recognition as if that embedded derivative were a freestanding derivative. Therefore, such an embedded derivative should be initially recorded at fair value and remeasured to its fair value in each reporting period. Unless the bifurcated embedded derivative is designated in a qualified hedging relationship, changes in the derivative's fair value are recognized through earnings in each reporting period.

## Standard-Setting Activity

### Has the FASB made recent changes to derivative accounting or are changes expected in the near future?

## Derivatives Scope Refinements (ASC 815) — FASB Recognition and Measurement Project

On July 23, 2024, the FASB issued a [proposed ASU](#) that would (1) refine the scope of the guidance on derivatives in ASC 815 and (2) clarify the scope of the guidance on share-based payments from a customer in ASC 606. The proposed ASU is intended to address concerns about the application of derivative accounting to contracts that have features based on the operations or activities of one of the parties to the contract and to reduce diversity in the accounting for share-based payments in revenue contracts. Comments on the proposal are due by October 21, 2024.

The proposed ASU would refine the scope of ASC 815 to exclude certain "contracts with underlyings based on operations or activities specific to one of the parties to the contract." Contracts that may qualify for this exception would include those in which the underlying is a business operation or an event such as obtaining regulatory approval or achieving specific business milestones. The proposal would also change how the "predominant characteristics" of a contract are assessed when a contract has multiple underlyings, some of which qualify for scope exceptions and some of which do not.

The proposed ASU would also clarify that when an entity has a right to receive a share-based payment from its customer in connection with a contract with that customer, the share-based payment would be accounted for as noncash consideration in the scope of ASC 606. That is, the proposed ASU provides that "unless and until the share-based payment is recognized as an asset" in accordance with ASC 606, the right to receive the share-based payment would not be in the scope of ASC 815 or ASC 321. Reporting entities would look to ASC 321 or ASC 815, as applicable, for **subsequent measurement**, which might result in the recognition of an immediate gain or loss once that share-based payment is received.

The Board will discuss feedback on the proposed ASU at future meetings. Entities should monitor this project on derivatives scope refinements with their accounting advisers for any new developments. For more information about the proposed ASU, see Deloitte’s August 2, 2024, [Heads Up](#).

### Definition of a Derivative — FASB Research Project

As of the date of this Roadmap, the FASB’s research agenda still includes a [project](#) on the definition of a derivative. The objective of the research project is to consider possible refinements to the scope of ASC 815, including potential application guidance specific to certain arrangements such as research and development funding arrangements and sustainability-linked financial instruments (see below). Although this remains a separate research agenda project, some of these objectives may be addressed by the derivative scope refinements project discussed above.

Entities should monitor this research project with their accounting advisers for any new developments.

**Sustainability-Linked Debt Instruments**

Entities that seek to demonstrate their corporate social responsibility may issue debt instruments whose payment terms vary depending on specified environmental factors (sometimes also referred to as sustainability factors). The inclusion of such features in debt instruments has become more common over the past several years as investors, credit rating agencies, lenders, regulators, policy makers, and other interested parties have increasingly focused on environmental, social, and governance (ESG) matters. Holders and issuers of sustainability-linked debt instruments must evaluate whether such arrangements contain an embedded feature or features that must be separately accounted for as a derivative under ASC 815-15. Given the wide variety of environmentally linked terms and the evolving nature of these instruments, entities are strongly encouraged to discuss their accounting analyses with their advisers. It is possible that the FASB’s project on derivative scope refinements (discussed above) could change the application of guidance that is relevant to these types of instruments and features, but no final standard has been released to date.

Deloitte’s Roadmap [Derivatives](#) provides a comprehensive discussion of the identification, classification, measurement, and presentation and disclosure of derivative instruments, including embedded derivatives. For further guidance on the application of hedge accounting to a qualified hedging relationship, see Deloitte’s Roadmap [Hedge Accounting](#).

### Contacts



**Jonathan Howard**  
Audit & Assurance  
Partner  
Deloitte & Touche LLP  
+1 203 761 3235  
[jonahoward@deloitte.com](mailto:jonahoward@deloitte.com)

For information about Deloitte’s derivatives accounting service offerings, please contact:



**Jamie Davis**  
Audit & Assurance  
Partner  
Deloitte & Touche LLP  
+1 312 486 0303  
[jamiedavis@deloitte.com](mailto:jamiedavis@deloitte.com)

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