



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:

Underlying, notional amount, payment provision	The contract contains both (1) “[o]ne or more underlyings” and (2) “[o]ne or more notional amounts or payment provisions or both.”
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.”
Net settlement	<p>“The contract can be settled net by any of the following means:</p> <ol style="list-style-type: none"> 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.”

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.

Not clearly and closely related	"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."
Hybrid instrument not measured at fair value on a recurring basis	"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."
Meets the definition of a derivative	"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?

Definition of a Derivative — FASB Research Project

As of the date of this Roadmap, the FASB's research agenda 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). 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.

Updates to Accounting for Convertible Instruments and Contracts on an Entity's Own Equity — ASU 2020-06

In August 2020, the FASB issued [ASU 2020-06](#), which simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity's own equity. In addition, ASU 2020-06 removes some of the required conditions for equity classification. Contracts on an entity's own equity that do not qualify as equity under ASC 815-40 must be accounted for at fair value, with changes in fair value recognized in earnings, irrespective of whether such contracts meet the definition of a derivative in ASC 815. For further details, see Deloitte's August 5, 2020, [Heads Up](#).

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
Partner
Deloitte & Touche LLP
+1 203 761 3235
jonahoward@deloitte.com

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



Jamie Davis
Partner
Deloitte & Touche LLP
+1 312 486 0303
jamedavis@deloitte.com

Dbriefs for Financial Executives

We invite you to participate in [Dbriefs](#), Deloitte's live webcasts that give you valuable insights into important developments affecting your business. Topics covered in the [Dbriefs for Financial Executives](#) series include financial reporting, tax accounting, business strategy, governance, and risk. Dbriefs also provide a convenient and flexible way to earn CPE credit — right at your desk.

Subscriptions

To subscribe to Dbriefs, or to receive accounting publications issued by Deloitte's Accounting and Reporting Services Department, please register at [My.Deloitte.com](https://my.deloitte.com).

The Deloitte Accounting Research Tool

Put a wealth of information at your fingertips. The Deloitte Accounting Research Tool (DART) is a comprehensive online library of accounting and financial disclosure literature. It contains material from the FASB, EITF, AICPA, PCAOB, and SEC, in addition to Deloitte's own accounting manuals and other interpretive guidance and publications.

Updated every business day, DART has an intuitive design and navigation system that, together with its powerful search and personalization features, enable users to quickly locate information anytime, from any device and any browser. While much of the content on DART is available at no cost, subscribers have access to premium content, such as Deloitte's *FASB Accounting Standards Codification Manual*. DART subscribers and others can also [subscribe](#) to *Weekly Accounting Roundup*, which provides links to recent news articles, publications, and other additions to DART. For more information, or to sign up for a free 30-day trial of premium DART content, visit dart.deloitte.com.

On the Radar is prepared by members of Deloitte's National Office. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

The services described herein are illustrative in nature and are intended to demonstrate our experience and capabilities in these areas; however, due to independence restrictions that may apply to audit clients (including affiliates) of Deloitte & Touche LLP, we may be unable to provide certain services based on individual facts and circumstances.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. In the United States, Deloitte refers to one or more of the US member firms of DTTL, their related entities that operate using the "Deloitte" name in the United States and their respective affiliates. Certain services may not be available to attest clients under the rules and regulations of public accounting. Please see www.deloitte.com/us/about to learn more about our global network of member firms.