MAZARS INSIGHTS
IFRS FOR FINANCIAL INSTRUMENTS
DERIVATIVES AND EMBEDDED DERIVATIVES

September 2019
INTRODUCTION

The Mazars Insight series on IFRS aim at helping preparers, users and auditors of financial statements develop their theoretical and practical understanding of IFRSs. Our objective is to provide our readers, whether beginners or experts, with useful tools which provide clarity and insight on the challenging issues that may be encountered when applying IFRSs. Concepts are explained in a pedagogical way and illustrated by numerous practical examples.

This IFRS Insight addresses the accounting for financial instruments under IFRS. It draws on several relevant IFRS standards to tackle, in one manual, the entire range of challenges related to financial instruments among which: recognition and derecognition, classification and measurement, impairment for credit risk, derivatives and hedging, and related disclosures. It includes all the new requirements introduced by IFRS 9 and the related amendments to other standards such as IFRS 7.

After a two-pager providing an overview of IFRS requirements for financial instruments in 10 key points, a table of content shows the list of chapters. Each chapter starts with a detailed table of content to direct readers straight to the topic they are searching for. Many cross references have been inserted for improved reading experience. We draw specific attention to chapter 2 which comprises the definitions and the list of abbreviations and acronyms used in this manual.

Our special thanks are addressed to the international team of authors who contributed to this manual: Egle Mockaityte, Florence Michel, Heike Hartenberger, Mohamed Taghia and Nicolas Millot. Additional thanks go to Isabelle Grauer-Gaynor, Marie Fossat and Marion Platevoet for their precious help in finalising this publication.

Vincent Guillard
IFRS Lead Partner for Financial Instruments
10 KEY POINTS TO REMEMBER

1. Scope
The accounting treatment of financial instruments under IFRS is defined by several standards. IFRS 9 – Financial Instruments provides requirements for recognition and derecognition, classification, measurement (including impairment) and hedge accounting. IAS 32 – Financial Instruments: Presentation provides principles for distinguishing issued debt and equity instruments as well as requirements for offsetting financial assets and financial liabilities. IFRS 7 – Financial Instruments: Disclosures deals with most of the disclosure requirements, and IFRS 13 – Fair Value Measurement provides guidance on fair value measurement and related disclosure requirements. Each of these standards has specific scope exclusions, even for items that meet the definition of financial instruments. (see chapter 1)

2. Initial recognition
All financial instruments are initially recognised when the entity becomes party to the contract. Financial assets or liabilities are initially measured at their fair value plus or minus transaction costs, except financial instruments classified at FV-PL for which transaction costs are directly expensed into profit or loss. However, trade receivables are initially measured at their transaction price if they do not contain a significant financing component in accordance with IFRS 15. When the transaction price differs from the initial fair value of that financial instrument, a so called “day one gain or loss” may need to be recognised upon initial recognition in profit or loss. (see chapter 6)

3. Classification of financial assets
Financial assets whose contractual cash flows are Solely Payments of Principal and Interest (the SPPI test) will be classified in accordance with the entity’s business model for managing the asset: Amortised Cost if they are subject to a Hold-To-Collect business model, FV-OCI if they are held within a Hold-To-Collect-and-Sell business model, or FV-PL in any other situation. Financial assets that do not pass the SPPI test (e.g. derivatives and equity instruments) must be classified in the FV-PL category, except for some equity instruments which the entity may irrevocably classify in FV-OCINR.

Subsequent reclassifications are limited to SPPI financial assets, upon a change in the entity’s business model and are thus expected to be very infrequent.

Subject to specific conditions (e.g. when a situation of an accounting mismatch would otherwise arise), an entity may irrevocably classify any financial asset as measured at FV-PL upon initial recognition. (see chapter 7)

4. Impairment for expected credit losses
Entities must recognise an allowance for expected credit losses for all financial assets classified in the Amortised Cost or FV-OCI category, as well as for most loan commitments and financial guarantees issued. Upon initial recognition of the instrument, the loss allowance is equal to the credit losses that the entity expects as a result from default events occurring within the next 12 months (12MECL). This amount is updated at each reporting date. When a Significant Increase in the Credit Risk (SICR) of the asset is identified, the loss allowance must be measured at an amount equal to the credit losses that the entity expects to occur over the full remaining life of the asset (LTECL).

Purchased or originated credit-impaired (POCI) assets (i.e. assets with existing incurred credit losses upon initial recognition) follow a separate impairment and revenue recognition model.
A simplified expected credit loss impairment approach is mandatory for short term trade receivables and contract assets, and optional for other trade receivables and contract assets, and lease receivables. (see chapter 9).

5. Classification of financial liabilities

Most financial liabilities are classified in the Amortised Cost category unless they are held for trading, or meet the conditions for a voluntarily classification in the FV-PL category upon their initial recognition. (see chapter 8)

6. Debt vs. Equity

Financial instruments issued that are in the scope of IAS 32 must be analysed to determine whether they meet the definition of an equity instrument or that of a financial liability. An instrument is generally classified as a financial liability if it requires the entity either to deliver cash or another financial asset, or to deliver a variable number of its own equity instruments. A derivative may qualify as an equity instrument if it will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of own equity instruments. Compound instruments contain both a liability and an equity component which must be accounted for separately.

7. Embedded derivatives

Derivative instruments may be either stand-alone contracts, or a feature embedded in a financial liability host contract or a non-financial host contract. Embedded derivatives must be bifurcated and accounted for separately as a stand-alone derivative if they are not economically closely related to their host contract. (see chapter 13)

8. Hedge accounting

Under IAS 39 and IFRS 9, most derivatives are by default measured at FV-PL whereas non-derivative financial assets and financial liabilities are often measured at amortised cost or FV-OCI. This situation may trigger accounting mismatches in profit or loss despite a proper economic offset between the hedging derivative and the hedged exposure. To better reflect the hedging strategy of the entity, IFRS 9 provides specific and optional accounting treatments for hedging relationships. The accounting impact depends on the nature of the hedging relationship (fair value hedge, cash flow hedge or net investment hedge). Hedge accounting is subject to eligibility, effectiveness and documentation-related conditions. (see chapter 14)

9. Derecognition

A financial asset is derecognised when and only when the contractual rights to the cash flows expire, or when the asset is transferred and this transfer meets the derecognition requirements. This test relies mainly on two criteria: the transfer of the contractual rights to the cash flows, and the transfer of the risks and rewards of ownership of the financial asset.

A financial liability is removed from the statement of financial position when it is extinguished. An exchange or modification of debt instruments, between an existing lender and borrower, is considered as an extinguishment of the original instrument if the terms of the original and the “new” instrument are substantially different.

10. Disclosures on financial instruments

The disclosure requirements aim at enabling the users to assess the significance of financial instruments for the entity, the nature and extent of risks arising from them, and how the entity manages those risks. (see chapter 16)
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### 13.1. General principles of accounting for derivatives

IFRS 9 requires that all stand-alone financial instruments that meet the definition of a derivative (see section 13.2.2) and that are in the scope of IFRS 9 (see chapter 1) be measured at fair value. There are however several exemptions from this requirement. They are dealt with in section 13.2.4.

Derivatives that are within the scope of IFRS 9 are initially recognised as an asset or a liability on the commitment date, i.e. when an entity becomes a party to the contract. For non-optional derivatives, the initial fair value is often equal to zero, whereas option-type derivatives have an initial fair value (option premium) that is different from zero. When the transaction price of a derivative does not correspond to its initial fair value, this may give rise to a gain or loss upon the initial recognition of that derivative (the so-called “day one gain or loss”), as described in chapter 6.

Fair value changes of derivatives between two reporting dates are recognised in profit or loss unless the entity has elected to apply hedge accounting by designating the derivative as a hedging instrument (see chapter 14).

#### Example 13.1

Consider a purchased option. In most cases the entity purchasing the option must pay the price of this option, the option premium, to its seller ("writer") at the inception of the contract. The option premium generally corresponds to the option’s initial fair value. Therefore, option premiums paid are not expensed in profit or loss directly, the corresponding entry upon the initial recognition of a purchased option (financial asset) will generally be simply a cash out entry. Supposing the option purchased is not documented as a hedging derivative (see chapter 14), it is subsequently measured at fair value through profit or loss until its maturity date. Only the changes of fair value of the option during the accounting period are recognised in profit or loss. Options are presented in more detail in section 13.2.1.3.3.

#### Example 13.2

Consider an interest rate swap (IRS), a common instrument that can be used to hedge, for instance, the interest rate risk of a financial debt bearing a floating interest rate. Generally, the initial fair value of an IRS is equal to zero. As a result, its initial recognition does not give rise to a specific accounting entry on the balance-sheet. Subsequently to its initial recognition, the fair value of an interest rate swap may be below or above zero. An interest rate swap with a fair value above zero is accounted for as a financial asset. An interest rate swap with a fair value below zero is accounted for as a financial liability. From one reporting date to another the same IRS may switch from an asset position to a liability position, and vice-versa. Whatever its balance sheet presentation, all changes in the fair value of the interest rate swap are recognised in profit or loss (unless the IRS is documented as a hedging instrument, as per chapter 14). Interest rate swaps are presented in section 13.2.1.3.2.

#### Example 13.3

Some swaps include an upfront or balloon cash payment, when at inception one of the “legs” of the swap is at off-market conditions. Upfront or balloon payments generally represent the initial fair value of the swap and must be accounted for as a financial asset (if upfront payment paid), or as a financial liability (if upfront payment received), and normally do not give rise to an immediate gain or loss. In case market conditions and other inputs considered in the valuation of the swap change subsequently, a swap with an initial upfront payment paid and therefore initially recognised as a financial asset may become a financial liability. Similarly, a swap with an initial upfront payment received initially recognised as a financial liability may become subsequently a financial asset.
CHAPTER 13: DERIVATIVES AND EMBEDDED DERIVATIVES

This requirement of FV-PL measurement extends to embedded derivatives accounted for separately from a hybrid contract (see section 13.3). A hybrid contract combines both a non-derivative host contract and an embedded derivative component. Any embedded derivative must be accounted for separately from its host contract if it meets the conditions in IFRS 9.4.3.3 (see section 13.3.3). However, separate accounting of embedded derivatives is prohibited for hybrid instruments measured at FV-PL. Hybrid contracts whose host contract is a financial asset are not subject to the embedded derivatives analysis as they undergo a specific test, the SPPI test (see section 7.4.3).

Section 13.2 will present stand-alone derivatives and section 13.3 will focus on embedded derivatives. Derivatives on own equity instruments, and compound instruments (instruments embodying both a debt component and an equity component) are addressed in chapter 5.

13.2. Stand-alone derivatives

Derivative contracts are not always well known and understood. The specific vocabulary for these instruments is often an additional hurdle to properly understand their features and behaviours. In section 13.2.1, we will first present common derivative transactions, their uses, purposes and characteristics. We will then focus on the IFRS 9 definition of derivatives (see section 13.2.2), their accounting treatment (see section 13.2.3) and finally present some exceptions (see section 13.2.4).

13.2.1. Common derivatives, their uses and characteristics

13.2.1.1. Typical uses of derivatives

Derivatives can be used to hedge against risks to which the entity is exposed (hedging) (see chapter 14), to speculate on price changes (trading) or to take advantage of price differences between markets (arbitrage).

13.2.1.2. Economic characteristics of derivatives

13.2.1.2.1. Value derived from a reference variable

In the banking language, the term “derivative” is used for financial instruments the price of which depends on the price movements in a reference variable, known as the underlying. There is a wide range of possible underlyings. Examples are shares, equity indices, government bonds, credit risk, currencies, interest rates, commodities like gold, copper, etc., or also other derivatives such as swaps. Changes in the price / level of the underlying lead to changes in the fair value of the derivative.

Example 13.4

The income of a farmer is generated from selling corn. His income is directly influenced by the change in the corn market price. To reduce uncertainty, the farmer could, for example, consider entering into a derivative contract whereby he will commit to deliver, in the future, a specified quantity of corn against a fixed price. However, there will be no physical delivery of the corn. Instead, the value of the contract will be calculated (applying the difference between the contractually agreed fixed price and the then current market price of corn to the agreed quantity of corn) and the farmer will receive any positive difference if the fixed price is
higher than current market conditions, or pay a negative difference if the fixed price is lower than the current market conditions.

Such contract economically reduces the farmer’s exposure to change in the underlying of the derivative contract: the corn market price. However, one can see that this contract remains “generic” as it will not take into account the actual quantity of corn that the farmer will be able to crop and sell. The derivative rather refers to a “notional” quantity of corn. Notional amount is another specificity of derivative further detailed in the next section.

13.2.1.2.2. Notional amount

The value of a derivative contract generally depends not only on the underlying variable(s) but also on the derivative’s notional amount. The notional amount is the basis on which the derivative’s value is calculated.

The notional amount may be expressed in units of a given currency, a number of shares, a number of units of weight or volume or other units specified in the contract (e.g. tons of wheat), etc. For most simple derivatives, the notional amount is the quantity applied to the change in value of the underlying to determine the contract value.

Everything being equal, if a derivative has a value of 10 for a notional amount of 2, the same derivative with a notional amount of 8 will generally have a value of 40.

13.2.1.2.3. Settlement provisions (net vs. gross settlement)

Depending on contractual provisions, a derivative can be:

- net-settled; or
- gross settled; or
- both, with a settlement option at the hand of one of the parties.

A net settlement is a one-way transfer of an asset, usually cash (in such case the term “net cash settlement” will be used), from the party in a liability position to the party in an asset position, settling the obligation.

A gross settlement consists in each party paying its obligation. Referring to example 13.1, a gross settlement would have consisted in the farmer delivering the agreed quantity of corn, and the counterparty paying the agreed fixed price in cash.

13.2.1.2.4. Where derivatives may be traded

Derivatives are traded either on futures and options exchanges on standardised terms, or over-the-counter (OTC) on freely negotiated terms. The exchange traded derivatives are often more liquid than OTC derivatives, and their market prices are directly observable.

Many OTC derivatives are documented using an ISDA (International Swaps and Derivatives Association) master agreement, which means their contractual terms are rather standardised even when treated over-the-counter.
13.2.1.3. Examples of commonly used derivatives

Typical examples of derivatives are forwards, futures, swaps and options. They are briefly described in this section.

13.2.1.3.1. Forwards and futures

Forwards are contracts entered into between two parties that require both parties to transact in the future at a pre-specified price known as the forward price. Forward contracts may relate both to financial or non-financial assets. The parties, the underlying and quantity of underlying are specified in the contract as well as the date of the future transaction (termination date) and the settlement options (in net, in gross / physically, or both). The payoff profiles of forward commitments are linear in nature and move upwards or downwards in direct relation to the price of the underlying asset. The fair value of a forward contract (as defined in chapter 3 Fair value measurement) is affected by changes in the spot rate and changes in the forward points.

On commitment date, the fair values of the rights and obligations of both parties are often equal and as a result the net fair value of the forward is equal to zero. If the net fair value of the right and obligation is not equal to zero, the contract is recognised as an asset or liability (IFRS 9.B3.1.2(c)).

Forward contracts are similar to futures contracts. The key difference between the two is that forward contracts are not traded on an exchange, they are transacted over-the-counter (i.e. directly between two parties) on freely negotiated terms. Being over-the-counter type contracts, forwards are less standardised than exchange-traded futures.

13.2.1.3.2. Swaps

A swap is a contract whereby two parties agree to exchange different payment flows (e.g. foreign currency or interest payments) during a specific term on fixed dates in the future.

Common swaps are interest rate swaps and foreign exchange swaps.

When an entity becomes a party to a swap contract, the fair values of the rights and obligations under the swap contract are often equal, so that the net fair value of the swap is equal to zero. If the net fair value of the rights and obligations is not equal to zero, the swap contract is initially recognised as an asset or liability (IFRS 9.B3.1.2(c)).

Example 13.5

Consider an interest rate swap (IRS). An IRS is an exchange of a fixed rate stream of payments (like a fixed rate bond) for a floating rate stream of payments (like a floating rate bond).

Suppose Entity A enters into an interest rate swap with a counterparty B that requires A to pay a fixed rate of 8 per cent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a CU100 million notional amount. A and B do not exchange the notional amount. A pays or receives a net cash amount each quarter based on the difference between 8 per cent and three-month LIBOR. Alternatively, settlement may be on a gross basis.
13.2.1.3.3. Options

An option is the right to purchase (call option) or sell (put option) the underlying asset (e.g. shares, bonds, commodities, foreign currency, etc.) from / to a counterparty at a previously agreed fixed price (strike). European options can be exercised only at a specified date (maturity date). American options can be exercised at any time over a defined period.

An option transaction is a conditional forward transaction in which the buyer acquires an optional right (option) with respect to an underlying.

A call option gives the holder the right to buy the underlying asset at a fixed price.

A put option provides the holder with the right to sell the underlying position at a fixed price.

The buyer of the call or put option must pay the seller of the option a premium (either immediately or, at some later point in time as is the case at some marketplaces where the premium payment is deferred until the expiration date). Buyers can decide not to exercise this right if this seems more favourable.

By contrast, the seller of a call or put option does not have the right to choose: as the option “seller”, the seller must carry out the transaction if the buyer exercises its option.

The risk profile of an option is very different depending on whether the option is purchased or sold:

— the maximum risk of a purchased option is limited to the premium paid and there may be no cap to the maximum potential gain;

— the maximum risk of a written option may not be capped. However, the maximum gain is capped to the premium received.

Options may be combined to get the risk profile desired by an entity. Some combinations may rely on a purchased option and a written option. The characteristics of such strategy may be fine-tuned in order to have a zero-cost strategy (the premium received on the written option equals the premium to be paid on the purchased option).

When it comes to their exercise date, there are different types of options:

— with a “European option”, buyers can exercise their optional right only at the end of the agreed term of the option transaction;

— with an “American option” this right can be exercised at any time over a specified period;

— a “Bermuda” option is a blend between an American option and a European option. The Bermuda option is exercisable at the expiration date, and on certain specified dates that occur between the purchase date and the date of expiration.

Option contracts are traded for a range of underlyings, such as shares, equity index futures, bond futures and commodities.

The table below provides a non-exhaustive list of examples of options and non-optional derivatives:
### Non-optional transactions

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### Example 13.6

An interest rate cap is an option with interest rate underlying that gives the buyer the right to receive a cash amount from the seller when a particular benchmark rate increases to a specified level (strike) at a point in time.

An interest rate cap is frequently purchased by entities to fix a maximum interest rate level for floating rate borrowings over a given period.

Assume that an entity has a floating rate borrowing with a nominal amount of CU1,000, paying Euribor 3 months every quarter, and with a maturity of 5 years. The entity purchased a cap the characteristics of which perfectly match those of the borrowing (nominal amount, currency, date of cash flow payment, etc.), with a strike of 5%. At a given quarter, the spot Euribor 3-month level is 6%. On the borrowing, the entity must pay an interest rate expense of 15 (6% x 1,000 x 90/360). The entity will receive from the seller of the cap a cash amount of 2.5 ((6%-5%) x 1,000 x 90/360). The net interest cost of the borrowing, taking into account the effect of the cap, will then be an expense of 5% even if the current market rate has risen to 6%.

If interest rates fall to 5%, the cap will not be exercised by the holder.

### 13.2.2. The IFRS 9 definition of a derivative

A derivative is any contract within the scope of IFRS 9 which meets all the three following features (IFRS 9 Appendix A):

- its value changes in response to the change in a specified underlying that can be an interest rate, the price of a financial instrument, a commodity price, a foreign exchange rate, an index of prices or rates, a credit rating or a credit index, or other variables, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (see section 13.2.2.1);

- it 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 (see section 13.2.2.2); and

- it is settled at a future date (see section 13.2.2.3).
An entity must assess a contract to determine whether it presents all the features of a derivative (IFRS 9. IG.B.2). Most typical derivatives traded under an ISDA master agreement (e.g. swaps, options, futures, forwards, etc.) will meet the IFRS 9 definition of a derivative. But there may be exceptions (see for instance the example of a prepaid forward in section 13.2.2.2.4 which does not meet the “initial net investment” criterion). Contracts that do not have the legal form of a derivative instrument (e.g. loan commitments or financial guarantees, or contracts to purchase non-financial instruments at a future date, etc.) may also meet the accounting definition of a derivative.

IFRS 9 provides specific exemptions for some contracts that meet the derivative definition, but that are nevertheless accounted for differently under IFRS 9 (see section 13.2.4).

13.2.2.1. The underlying variable

13.2.2.1.1. Value derived from an underlying variable

Derivative instruments are contracts the value of which is derived from changes in a specific variable.

Many contracts that have an underlying, whatever their legal form (e.g. forward purchase contracts, guarantees, loan commitments, etc.) may meet the definition of a derivative (IFRS 9.IG.B.2). Not all such instruments are however in the scope of IFRS 9 (see chapter 1).

An underlying is a variable that, along with other parameters such as a notional amount or a payment provision, determines the settlement of a derivative instrument. Its changes in value cause the fair value of a derivative to fluctuate (e.g. the 3-month Euribor index in an interest rate swap).

An underlying can also be binary / digital in its nature, acting as an “on / off” switch, as in the occurrence or non-occurrence of a specified event. The occurrence or non-occurrence of an event can trigger a fixed or a formula-driven payment.

13.2.2.1.2. Non-financial variable specific to a party of the contract

To meet the definition of a derivative, IFRS 9 requires that a non-financial underlying to not be specific to a party to the contract (this does not apply to a financial underlying). Examples of a non-financial underlying include, for instance, an index of earthquake losses in a specific region and an index of temperatures in a given city.

However, if the contract refers to a non-financial variable that is specific to a party to the contract, this contract is not a derivative. Examples of non-financial variables specific to a party to the contract include:

- cash flows indexed to the financial ratios of one of the parties (e.g. EBITDA);
- the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract (IFRS 9.BA.5);
- a change in the fair value of a non-financial asset where the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). Such underlying is specific to the parties to the contract. For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car’s physical condition, the change in that residual value is specific to the owner of the car (IFRS 9.BA.5).
13.2.2.2. Initial investment

13.2.2.2.1. General principle

One of the defining characteristics of a derivative is that it has 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 (IFRS 9.BA.3).

Derivatives are unique in that the counterparties to the contract generally do not have to initially invest in, own or exchange an associated asset or liability. Therefore, there is commonly no exchange of cash (or a relatively small investment) at the date the counterparties enter into the contract. Most derivatives do not require any initial investment. For instance:

- swaps or forward contracts generally do not require an initial net investment unless the terms favour one party over the other, or unless they contain a financing element and as such are prepaid (see below);
- commodity futures contracts generally require no net investment, while purchasing the same commodity requires an initial net investment equal to its market price. Both contracts reflect changes in the price of the commodity in the same way (similar gains or losses will be incurred).

The relationship between this nil or small initial net investment compared to the underlying price is often referred to as a leverage. Any derivative instrument under IFRS 9 will provide such leverage to the parties to the contract.

Some derivatives require an initial net investment as a compensation for the time value (e.g. a premium on an option, because that party has a right under the contract and the other party has an obligation). Other derivatives have terms that are more or less favourable than market conditions (e.g. a premium on a forward contract to buy shares with a forward price that is lower than the current forward price). In addition, derivatives could require a mutual exchange of currencies or other assets at inception, in which case it is the amount of the net investment that must be analysed (i.e. the difference between the fair values of the assets exchanged).

13.2.2.2.2. Currency swaps

Currency swap contracts can require an exchange of the underlying currencies not only at maturity but also at inception. The initial exchange of currencies typically occurs at fair value (at spot exchange rates). This exchange is considered to be the exchange of one kind of cash for another kind of cash at the same value. The initial investment is, therefore, considered to be the difference in the values, if any, that are exchanged.

A currency swap that requires an initial exchange of different currencies of equal fair values meets also the definition because it has a zero-initial net investment (IFRS 9.BA.3).

13.2.2.2.3. Options

When an entity purchases an option it generally pays a premium for the right it obtains to exercise the option. Whether or not the option meets the definition of a derivative under IFRS 9 will depend on the amount of the premium compared to the price of the underlying.
**Example 13.7**

If an entity pays CU10 to purchase a call on a security the fair value of which is 100, the call may be qualified as a derivative. However, if the entity purchases the call at a price of 90, the leverage provided by the option will not be sufficient to meet the definition of a derivative.

In practice however, option contracts generally meet the definition of a derivative because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked (IFRS 9.BA.3).

**13.2.2.2.4. Prepaid derivative instruments**

Forward contracts which require an upfront cash prepayment of the forward purchase or sale price (prepaid forward) do not meet the definition of a derivative under IFRS 9 as they do not meet the initial net investment criterion. Prepaid contracts do not have an initial nil 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 the test of the market factors for a derivative.

**Example 13.8**

An entity enters into a prepaid forward contract to purchase, for instance, shares of entity A in one year at the forward price. The current market price (€2.000) is less than the one-year forward price (€2.099) of these shares. The entity is required to prepay the forward purchase price at inception at an amount equal to the current market price of the shares. The initial investment in the forward contract at its spot market price is less than the forward price but it approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors, because the shares of entity A could be purchased at inception for the current market price (IFRS 9.IG.B.9).

In situations where only part of the forward price is prepaid at inception by one of the parties to the contract, entities should exercise judgement to assess whether the initial net investment is smaller or not than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

IFRS 9 does not provide guidance on how to account for prepaid forwards that do not meet the definition of a derivative.

In our opinion, these transactions should be treated as hybrid financial assets or liabilities. The accounting treatment will depend on whether the party prepays or receives the prepayment:

- the party that pays the prepayment amount will have to account for a hybrid asset which, given the exposure to the contractually specified underlying variable, in many cases will not meet the SPPI criterion described in section 7.4.3;
- the party that receives the upfront payment will have to account for a hybrid financial liability containing an embedded derivative, as per section 13.3.5.3.
Example 13.9

Consider a pay-fixed, receive-variable interest rate swap where the entity prepays its obligations under the fixed leg of the swap at inception (IFRS 9.IG.B.4).

Entity A enters into a CU100 million notional amount five-year pay-fixed, receive-variable interest rate swap with entity B. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month Libor. The interest rate of the fixed leg of the swap is 10% per year. Entity A prepays at inception its fixed leg payments under the swap for the total amount of CU50 million (CU100 million x 10 per cent x 5 years), discounted using market interest rates, while retaining the right to receive floating interest rate payments on the CU100 million notional amount over the life of the swap, with the floating rate being reset quarterly based on three-month Libor.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than what would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond. Therefore, the contract fulfils the “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” provision of IFRS 9. Even though entity A has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the Libor index. Accordingly, the contract is accounted for as a derivative contract.

A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows (see section 13.2.2.2). The prepaid amount fails the “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” criterion of a derivative.

Example 13.10

Now consider a pay-variable, receive-fixed interest rate swap where the entity prepays its obligations under the variable leg of the swap at inception (IFRS 9.IG.B.5).

An entity A enters into a CU100 million notional amount five-year pay-variable, receive-fixed interest rate swap with entity B. The variable leg of the swap is reset on a quarterly basis to 3-month Libor. The fixed interest payments under the swap are calculated as 10% x the swap’s notional amount, e.g. CU10 million per year.

Entity A prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10% on CU100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since entity A knows it will receive CU10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment of this prepaid interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the “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” criterion of IFRS 9. Therefore, the contract is not accounted for as a derivative under IFRS 9.

By discharging the obligation to pay variable interest rate payments, entity A in effect provides a loan to entity B (IFRS 9.IG.B.5).
13.2.2.3. Future settlement

13.2.2.3.1. Settlement at a future date

As explained, the third part of the definition of derivatives is that they should be settled at a future date. So, spot transactions (e.g. spot purchases of currency) are not derivatives. The spot market is a financial market in which financial instruments or commodities are traded for immediate delivery. It contrasts with a forward (or future) market, in which delivery is due at a later date.

13.2.2.3.2. Settlement provisions

As explained in section 13.2.1.2.3, many derivatives may be settled gross (by physical delivery of the underlying against cash) or net (where only the net difference between the then-observed market value of the underlying and the pre-determined / forward price is exchanged). The contract may also offer the choice of settlement to one party of the contract.

The IFRS 9 definition of a derivative does not depend on the settlement pattern of the contract. However, the settlement mode (net or gross) is an essential feature of a derivative and will impact the eligibility or not of the contract for specific treatments under IFRS 9 / exceptions:

— **Regular-way purchases / sales** of financial assets (see section 13.2.2.3.3): contracts which require or permit net settlement of the change in the value of the contract are not regular way transactions. They are accounted for as derivatives in the period between the trade date and the settlement date (IFRS 9.B3.1.4). Regular way contracts are further defined in chapter 6.

— **Own-use derivatives** contracts to buy or sell non-financial assets that can only be net cash-settled do not qualify for the own-use exception and must be accounted for as derivatives. Own-use contracts are further defined in chapter 1.

— **Own equity instruments**: derivative contracts on own equity instruments that are not settled only on a gross physical settlement basis cannot be qualified as equity instruments. Derivatives on own equity instruments are further defined in chapter 5.

13.2.2.3.3. Regular way purchases and sales of financial assets

Some transactions relating to financial assets (e.g. purchases of bonds) may take several days to be settled, i.e. there is a several-day lag between the trade date (on which the contract is entered into) and the settlement date (on which the bonds are received for a cash payment). Suppose that this bond purchase is a "regular-way" purchase of bonds in the marketplace concerned (i.e. the delivery of the asset is required within the time frame established generally by regulation or convention in that marketplace) and that the entity opts for settlement date accounting for such financial assets (see chapter 6). No derivative will be recognised during this short period between the trade date and the settlement date, despite the fact that:

— the transaction is settled at a (close) future date,
— it has an underlying (bond price) that drives its value
— and it requires no initial net investment (no payment before the settlement date).

This is because of the initial recognition requirements in IFRS 9 for regular way purchases and sales of financial assets (see chapter 6).
However, when the settlement of such a purchase takes more time than commonly established by regulation or convention in the marketplace concerned, the bond purchase may not be qualified as a regular-way purchase and a derivative (forward to buy bonds) will have to be accounted for until the settlement date.

13.2.3. General principles of accounting for stand-alone derivatives that are not documented as hedges

A derivative in the scope of IFRS 9 is recognised as an asset or a liability on the commitment date (IFRS 9. B3.1.2(c)).

When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal. The net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or a liability (IFRS 9.B3.1.2(c)).

An entity must initially measure a derivative at its fair value. Transaction costs that are directly attributable to the acquisition or issue of the derivative are recognised in profit or loss when incurred.

All derivatives that are within the scope of IFRS 9, but not documented in a hedging relationship, are classified as Held for Trading (IFRS 9 appendix A) and measured at fair value through profit or loss (see section 13.2.4 for more details on derivative scope exemptions). The changes in the fair values of derivatives are accounted for in profit or loss at each reporting date.

IFRS fair value measurement is explained in chapter 3.

For derivatives documented in a hedging relationship, specific treatment may apply (see chapter 14).

13.2.4. Exemptions

Not all derivatives (even when they have all the typical characteristics of a derivative) are to be measured at FV-PL. IFRS 9 contains the following derivative specific scope exemptions (see chapter 1):

— contracts to buy or sell non-financial assets that are entered into for the receipt of the non-financial item in accordance with the entity’s expected purchase, sale or usage requirements (“own-use” contracts);
— insurance contracts;
— some financial guarantees;
— loan origination commitments for borrowers and certain loan origination commitments for lenders;
— some derivatives on own equity instruments that meet the definition of equity instruments;
— forward contracts between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date.

Besides, specific requirements exist for “Regular-way” purchases and sales of financial assets (see section 13.2.2.3.3).
13.3. Embedded derivatives

13.3.1. Introduction

Most stand-alone derivatives within the scope of IFRS 9 and not documented in a hedging relationship are measured at fair value through profit or loss. Entities might be tempted to avoid recording in profit or loss the volatility resulting from derivatives by hiding them into non-derivative host contracts.

A hybrid contract is any contract that contains both a non-derivative host contract and an embedded derivative.

As an anti-abuse measure, the IASB introduced the embedded derivatives requirements to IAS 39, to make sure most “hidden” derivatives give rise to the same impacts in profit or loss as stand-alone derivatives. The rationale for the requirement to separate particular embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract, for example, by embedding a commodity forward in a debt instrument (IFRS 9.BCZ4.102).

This concept of embedded derivative is carried forward under IFRS 9 for hybrid contracts containing a host non-financial contracts or a host financial liabilities. However, as financial assets are subject to a dedicated characteristics test under IFRS 9 (the “Solely payments of principal and interest” test), hybrid contracts containing a host financial asset are not subject to the embedded derivatives requirements.

13.3.2. Definitions

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative contract (IFRS 9.4.3.1).

An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to 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 (IFRS 9.4.3.1).

An embedded derivative is a derivative that is attached to the host contract and is not contractually transferable independently. It always has the same counterparty as the host contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument (IFRS 9.4.3.1).

It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument (“synthetic instrument” accounting) for the purpose of applying IFRS 9, in particular when each of these financial instruments has its own terms and conditions and may be transferred or settled separately. Therefore, as a general principle non-derivative financial instruments and derivatives are classified separately (IFRS 9.IG.C.6). Please refer also to section 13.4.
Example 13.11

Consider an entity A investing in a convertible bond issued by entity B. The bond pays a fixed interest rate on a yearly basis. Upon bond maturity, the holder has the possibility either to be reimbursed from B the nominal amount of the bonds, or to receive in cash an amount equal to the fair value of entity C shares.

This convertible bond meets the definition of a hybrid contract. The host contract is a vanilla fixed rate bond, and the embedded derivative is a call option on entity C shares. The strike of the call is the redemption price of the bond.

Example 13.12

Consider the same fact pattern as in example 13.11, except that the holder of the convertible bond has the right to sell separately the conversion option (call) to a third party.

In such case, the convertible bond will not be considered as a hybrid contract. Entity A and entity B will account for this transaction by recognising separately the fixed rate bond, and a stand-alone call option.

13.3.3. Hybrid contracts – when must embedded derivative requirements be applied?

When an entity becomes a party to a hybrid contract the host contract of which is not a financial asset (such as hybrid contract with financial liability host, non-financial contract host, etc.), the entity has to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as stand-alone derivatives under IFRS 9.

When an entity becomes a party to a hybrid contract with a host that is a financial asset within the scope of IFRS 9, the entity must apply the classification requirements of IFRS 9 for financial assets (see chapter 7) to the entire hybrid contract (IFRS 9.4.3.2). Derivatives embedded in financial asset host contracts are never bifurcated. However, the impact of the embedded derivative on the hybrid contract cash flows will be captured within the characteristics test of the financial asset classification procedure (SPPI Test).

The figure below summarises the scope of the embedded derivative analysis.

Figure 13.2

<table>
<thead>
<tr>
<th>Hybrid contracts with financial asset hosts (IFRS 9.4.3.2)</th>
<th>Other hybrid contracts (IFRS 9.4.3.3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>If a hybrid contract contains a host that is an asset within the scope of IFRS 9, the entity must apply the requirements on classification of financial assets (see chapter 7), including the SPPI characteristic test, to the entire hybrid contract.</td>
<td>If the host contract is a financial liability, a loan commitment excluded from the scope of the classification requirements in IFRS 9, an insurance contract or a non-financial host contract, the entity will have to assess the terms of the hybrid contract to establish whether the embedded derivative must be bifurcated.</td>
</tr>
</tbody>
</table>
Example 13.13

Entity A invests in a convertible bond issued by entity B. The convertible bond pays a fixed-rate annual coupon and has a maturity of three years. At any point prior to the bond’s maturity, entity A has the option to convert the bond into a fixed number of shares of entity C.

The host-contract being a financial asset, entity A would analyse the convertible bond in its entirety. The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement (IFRS 9. B4.1.7A), i.e. the return is linked to the value of the change in value of entity C shares.

This asset does not meet the SPPI criterion, so the convertible bond should be classified at FV-PL in its entirety.

13.3.4. Accounting for hybrid contracts subject to the embedded derivative requirements

13.3.4.1. General principles

For all hybrid contracts that are not financial assets within the scope of IFRS 9, the entity must apply the following 3-step approach upon initial recognition of the contract:

— identify the embedded derivative(s) (see section 13.3.2);
— for each embedded derivative identified, determine whether it is required to be bifurcated from the host contract (see below); and
— for those embedded derivatives that are required to be accounted for separately, measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss (IFRS 9.B4.3.1, see section 13.3.6).

The assessment of whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative should be made on the basis of the circumstances that existed when the entity first becomes a party to the contract.

An embedded derivative must be separated from the host contract (that is not a financial asset) and accounted for as a stand alone derivative under IFRS 9 if, and only if:

— the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see section 13.3.5);
— a separate instrument with the same terms as the embedded derivative would meet the definition of a (stand-alone) derivative (see section 13.3.2); and
— the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (IFRS 9.4.3.3). For instance, a derivative that is embedded in a financial liability measured at FV-PL must not be bifurcated.
If an embedded derivative meets the three criteria for bifurcation, the hybrid contract, a single contract from the legal documentation standpoint, must be “split” into two units of account:

- the host contract, which is accounted for in accordance with the appropriate standards (IFRS 9.4.3.4), and
- the separated embedded derivative, which is accounted for as a stand-alone derivative (see section 13.2.3). This means generally that, unless it is documented as a hedge in accordance with hedging requirements explained in chapter 14, the embedded derivative that has been separated will be measured at fair value, with the changes from one reporting date to another being reported in profit or loss.

IFRS 9 does not address whether a bifurcated embedded derivative should be presented separately in the balance-sheet (IFRS 9.4.3.4).

However, split accounting in such situations is not required if the entity designates the entire hybrid contract as measured at FV-PL, as explained in the following section.

### 13.3.4.2. Hybrid instruments designated as measured at FV-PL

The requirements for separating non-closely-related embedded derivatives presented on the preceding section can be complex to implement or potentially result in less reliable measures (IFRS 9.B4.3.9). That is why IFRS 9 permits (or in some cases requires) designating the entire hybrid contract as measured at fair value through profit or loss.

Designation at FV-PL is **required** if an entity is required by IFRS 9 to separate an embedded derivative from its host contract but is **unable to measure** the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period (IFRS 9.4.3.6). For more complex instruments, the fair value of the combined contracts may be significantly easier to measure and hence be more reliable than the fair value of only those embedded derivatives that are required to be separated (IFRS 9.BCZ.4.69).
An entity is unable to measure the embedded derivative when both:

— the entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, and

— the entity is unable to measure the fair value of the embedded derivative as a difference between the fair value of the hybrid contract and the fair value of the host contract (IFRS 9.4.3.7).

Designation at FV-PL of a hybrid contract to avoid the bifurcation of the embedded derivative is permitted except in the following two scenarios, where measurement at FV-PL would not reduce complexity or would not increase reliability (IFRS 9.B4.3.10):

— the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract (IFRS 9.4.3.5); or

— it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited (IFRS 9.4.3.5 and IFRS 9.BCZ.4.70).

To reliably identify and measure the separate components, an entity that enters into sophisticated investment and funding strategies such as structured notes or other contracts with embedded derivatives should obtain the information necessary to perform separate valuation. As such information may not always be easy to obtain in practice, some entities opt for a systematical designation at FV-PL in their entirety for eligible hybrid instruments with complex embedded derivatives.

13.3.5. Determining whether the embedded derivative is “closely-related”

13.3.5.1. Presentation of the “closely-related” criterion

One of the most critical parts of the embedded derivative analysis process consists in determining whether the embedded derivative is “closely-related” to the host contract. Indeed, IFRS 9.4.3.3 states that an embedded derivative must be bifurcated if, and only if, its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract.

IFRS 9 do not provide a clear definition of what is meant by “closely-related”. However, it provides several examples of closely-related embedded derivatives and non-closely-related embedded derivatives.

In analysing these examples, we note that two main principles are consistently applied. An embedded derivative cannot be closely-related to its host contract each time that:

— it brings to the hybrid contract an underlying that does not exist in the host contract, or

— it introduces to the contract a leverage effect that did not exist in the host contract.

However, given the lack of clear guidance, judgement is often required to perform this “closely-related” analysis.

We will first look at the range of host contracts that can be identified (see section 13.3.5.2) and then illustrate this closely-related concept further through several illustrative examples.
13.3.5.2. Identifying host contracts

Host contracts can be a financial instrument or a non-financial instrument.

13.3.5.2.1. Financial instrument host contract

Hybrid instruments that have financial asset host contracts that are within the scope of IFRS 9, are not subject to the embedded derivatives assessment (see section 13.3.3).

If a financial instrument host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related (IFRS 9.B4.3.2).

If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument (IFRS 9.B4.3.2). Debt instruments in practice often correspond to instruments having the legal form of borrowings (loans or quoted debt securities such as bonds / notes). Such instruments are naturally exposed to risks typically present in financing transactions, such as interest rate risk and credit risk of the borrower.

Some financial instruments are excluded from the scope of IFRS 9, but the standard states explicitly that the embedded derivative guidance is nevertheless applied to (IFRS 9.2.1):

- host lease contracts in the scope of IAS 17 / IFRS 16, and
- host contracts (mainly insurance contracts) in the scope of IFRS 4 / IFRS 17.

13.3.5.2.2. Non-financial host contract

IFRS standards do not limit the scope of non-financial contracts that are subject to the embedded derivative requirement.

In practice, an embedded derivative feature may thus be identified in any type of contract to deliver service or goods.

13.3.5.3. The “closely-related” criterion – debt host contracts

13.3.5.3.1. Interest rate leverage features

IFRS 9.B4.3.8(a) states that 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 is generally closely related to the host contract, but it will be regarded as not closely related in the following situations:
— when the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment, or

— when the embedded derivative could at least:

> double the holder’s initial rate of return on the host contract; and

> 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. (These criteria are sometimes referred to as the “double-double test”).

This example typically illustrates the concept of leverage effect introduced in a debt instrument by an embedded derivative. While IFRS 9 is mainly principle-based, this example provides clear thresholds to determine the level from which the leverage introduced is considered as too significant to consider that the embedded derivative is closely-related to its host contract.

The condition that “the holder would not recover substantially all of its recognised investment” applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder to not recover substantially all of its recognised investment (IFRS 9.IG.C.10). If, for example, the terms of a hybrid contract permit, but do not require, the holder to settle the hybrid contract in a way that causes the holder not to recover substantially all of its recognised investment and the issuer does not have such a right (for example, when this is a puttable debt instrument), the feature is considered closely related to the host contract. This is because the issuer does not have a right to oblige the holder to lose its investment.

IFRS 9 does not define the term “substantially all of its recognised investments”. An entity must consider all relevant facts and circumstances in its judgement.

The analysis focuses on the situation where the holder would not recover substantially all of its investment as a consequence of the interest rate embedded derivative. The possibility that recovery may not occur due to credit or default risk must not be considered in this analysis.

“Substantially all” in IFRS 9.B4.3.8(a) implies that embedded clauses that may lead to a slight negative yield or an insignificant failure to recover principal do not fail the “closely-related” criterion.

Regarding the 2nd criterion (not closely related if it may double the rate of return), to be considered as not closely related to the host contract, the embedded derivative must (over the life of the contract) be able to both double the initial rate of return and result in a rate of return that is at least twice what would otherwise be expected for a similar host contract at the time it takes effect (same terms as the host contract and same credit risk as the issuer’s).

IFRS 9 thus considers that if an interest rate embedded derivative leads a debt contract to bear an interest rate that is significantly different both from a fixed interest rate (first condition) and a floating interest rate (second condition), then it cannot be considered as closely related to the debt host contract.
A common example of such notes where the "double-double" test is often met at inception is indexation on CMS (constant maturity swap) rates. Should a bond with a 15-year maturity be indexed to, say, a CMS 10-year rate, the double-double condition would not be met and the embedded indexation to the CMS 10-year rate would not be considered closely related to the host debt contracts in the issuer’s statements. This is because, supposing a comparable fixed rate for the 15-year period is 5%, both of the following scenarios may not be ruled out at inception:

- the possibility that the CMS 10-year rate, over the 15-year term, reaches or exceeds 10% (i.e. it could double the initial fixed-rate of return), and
- the possibility that the CMS 10-year rate, over the 15-year term, reaches or exceeds twice the level of a comparable vanilla floating rate, such as Euribor 12-months, supposing the coupon on this bond is reset every 12 months.

In practice, a cap to the CMS indexation (say at 9.5% in the example) is generally introduced in the contractual interest rate formula. This cap grants that the instrument cannot double the initial rate of return of a fixed rate debt instrument with similar characteristics. Consequently, the leveraged effect is capped below the bifurcation threshold of IFRS 9 and the embedded derivative must not be bifurcated.

13.3.5.3.2. Interest rates caps and floors

An embedded floor or cap on the interest rate in a debt host 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 (IFRS 9.B4.3.8(b)).

13.3.5.3.3. Interest step-up / step-down features

IFRS 9 does not specifically deal with contingent step-up features.
To determine the accounting qualification of a contingent step-up or step-down feature, the nature of the interest revision trigger should first be carefully analysed.

Triggers that are specific to the parties to the contract (such as breach of a contractual covenant by the borrower or the borrower’s default on its contractual payment obligations), do not meet the definition of a derivative (see section 13.2.2). As a result, these triggers do not constitute an embedded derivative, and do not have to be separated from the host debt contract.

Example 13.14

A common example of a contingent interest feature is one requiring additional interest on a failure to comply with a debt contractual covenant. Such feature does not meet the definition of a derivative as the covenant is a non-financial variable that is specific to a party to the contract. It therefore cannot be qualified as an embedded derivative.

Triggers that refer to observable market variables that are not specific to parties to the contract: provided the trigger meets the definition of an embedded derivative, a case-by-case analysis should be performed to assess whether the trigger may be considered as closely related to the host debt instrument. For instance, triggers that do not directly relate to the credit worthiness of the borrower may need to be separated. In our opinion, a reset based on a change in another entity’s credit default spread or a change in an equity index should not be considered as closely related.

Example 13.15

A contingent interest feature that increases the interest rate of the instrument if the market price of the issuer’s ordinary shares falls (or rises) to a specified level should be bifurcated and separately accounted for. The equity underlying is not closely related to the host debt contract.

13.3.5.3.4. Embedded inflation-related derivatives

The primary purpose of inflation derivatives is the transfer of inflation risk. Inflation derivatives may be embedded in debt instruments such as bonds. The derivative component and the host debt financial instrument form together a hybrid instrument, a so-called inflation-linked bond. The inflation indexation may be introduced in different ways (interest indexed to inflation, fixed rate of interest applied to an inflated nominal, etc.).

IFRS 9 does not contain any specific guidance on how inflation-linked bonds should be analysed by their issuer (for the analysis in the financial statements of the investor, please refer to chapter 7 Classification of financial assets).
In our opinion, the inflation-related derivative embedded in inflation-linked bonds should be analysed by analogy to the principles set out in IFRS 9 for inflation-indexed lease payments (see section 13.3.5.5).

As a result, such derivatives would be considered as closely related to the host debt contract when both conditions are met:

— the inflation-linking feature is not leveraged, and
— the index relates to inflation in the entity’s own economic environment.

In our opinion, a leverage is observed when a coefficient > 1 is applied to the contractual inflation index (e.g. 1.5 x yearly CPI level for an instrument with yearly coupons).

13.3.5.3.5. Embedded credit derivatives

The initial step when analysing embedded credit risk-related features is to analyse whether they relate to the credit risk of the borrower or to a third party / a reference asset.

Embedded credit-risk features that relate to the borrower generally may not require bifurcation as the derivative shares the same credit risk underlying as the debt host contract. Attention would have to be paid nevertheless to the existence of any significant leverage.

Embedded credit risk features that relate to a third party or a specific asset will generally not be considered as closely related to the host debt contract because it introduces a new underlying to the host debt contract. IFRS 9.B4.3.5(f) indicates that credit derivatives that 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. This is because such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

Consider an instrument such as an ABS (asset-backed-security) or a CLO (collateralised loan obligation) resulting from a securitisation. Such investments, which introduce a tranching of credit risk of the underlying assets via the waterfall structure of cash flows, allow investors to gain exposure to the underlying assets without owning them. The waterfall feature itself does not normally result in the separation of an embedded credit derivative. However, the ownership by the issuer of the reference asset is a key element in determining whether the embedded credit derivative is closely linked to the host debt contract or not. Therefore, synthetic CLOs (where the issuer gains exposure to the reference assets by writing CDSs on these assets instead of investing in them) contain non-closely related credit derivatives that are to be bifurcated by the issuer, unless the issuer measures the entire hybrid instrument at FV-PL.

13.3.5.3.6. Embedded equity derivatives

The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (IFRS 9.4.3.3(a)). We illustrate hereafter this principle using examples from IFRS 9:
— 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 price or index is not closely related to a host debt instrument (IFRS 9.B4.3.5(a)). This is because the principal payment may increase or decrease depending on the change in the underlying equity price or index (IFRS 9.B4.3.6).

— Equity-indexed interest or principal payments embedded in a host debt instrument - 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 (IFRS 9.B4.3.5(c)).

Example 13.16

Consider an Equity-Linked Note (ELN). An equity-linked note combines the risk and return characteristics of a debt instrument and an equity derivative providing a performance based on the change in common stock prices or a specified equity index. The embedded equity derivative and the debt host instrument are not closely related.

Example 13.17

Consider a bond with a step-up that is contingent on equity returns. The contingency basis for determining the step-up could be any variable but, in this example, the step-ups are indexed to the rate of return earned on a selected portfolio of 30 equity securities. The step-up feature embedded in this contract is indexed to equity prices, and as a result the host debt contract and the embedded derivative are not closely related.

13.3.5.3.7. Embedded commodity derivatives

Embedded derivatives introducing exposure to changes in prices of non-financial assets such as commodities are not closely related to the host debt contract.

IFRS 9 contains the following examples of host debt contracts where the embedded commodity derivatives are not closely related:

— 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 a commodity price or index is not closely related to a host debt instrument (IFRS 9.B4.3.5(a)).

— Commodity-indexed interest or principal payments embedded in a host debt 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 (IFRS 9.B4.3.5(d)).

13.3.5.3.8. Embedded currency derivatives

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 (for example, 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, The Effects of Changes in Foreign Exchange Rates, requires foreign currency gains and losses on monetary items to be recognised in profit or loss (IFRS 9.B4.3.8(c)).
13.3.5.3.9. Call, put and prepayment options

Callable bonds\(^1\) are securities consisting of a host debt instrument and an option granting the issuer the right to redeem the instrument before maturity under specified conditions. In general, the contractual interest rate is higher for callable bonds compared to similar non-callable bonds because the issuer pays investors a price for obtaining the right to redeem the debt instrument before maturity. Puttable bonds are securities consisting of a host debt instrument and an option granting the holder / investor the right to redeem or retire the financial instrument before maturity under specified conditions. The contractual prepayment terms must be carefully analysed to assess whether they are closely related or not to the host debt contract.

IFRS 9.B4.3.5(e) states that embedded call or put options that can accelerate the repayment of principal on debt are considered to be not closely related to the host debt contract or host insurance contract, unless the call / put feature meets one of the two conditions:

- the option’s exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument; or
- the exercise price of the 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 (IFRS 9. B4.3.5(e)).

Paragraph B4.3.5(a) of IFRS 9 further requires that the put / call feature must not be indexed to “exotic” underlying variables (such as equity or commodity price or index) for that calls or put to be considered as “closely related” to the host debt contract.

**Example 13.18**

Consider a debt instrument that has been issued at par and is callable at any time during its 10-year term (it contains the so-called “American-style” option). If the debt instrument is called, the investor receives the par value of the debt instrument and the unpaid and accrued interest. No significant issue costs have been incurred initially (i.e. Initial amortised cost equals the par value).

The embedded call option is closely related to the debt instrument host contract because (a) the payoff is not indexed (i.e. the repayment amount does not depend on a commodity or an equity index) and (b) the call option’s exercise price is approximately equal on each exercise date to the amortised cost.

**Example 13.19**

Consider another debt instrument that is issued at par and callable at any time during its term. If the debt instrument is called, the investor receives the greater of the par value of the debt instrument or the market value of 10 shares of a third party.

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\(^1\) This section only deals with callable bonds issued. Callable/ puttable bonds held are to undergo the SPPI analysis and IFRS 9 contains specific guidance for such bonds, as specified in section 7.4.3.3.2.
The embedded call option is not closely related to the debt instrument host contract because the payoff is indexed to an equity price.

13.3.5.3.10. Term-extending options

According to IFRS 9.B4.3.5(b), an option or automatic provision to extend the remaining term to maturity of an issued 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.

13.3.5.4. The “closely-related” criterion – equity host contracts

Hybrid instruments with equity host contracts are much less common than hybrid instruments with debt host contracts.

IFRS 9 does not provide any example of derivatives embedded in an equity host contract. The standard simply states that an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related to its host equity contract (IFRS 9.B4.3.2).

13.3.5.5. The “closely-related” criterion - lease host contracts

IFRS 9 paragraph B4.3.8(f) provides three examples of features that would not trigger the bifurcation of an embedded derivative from a host lease contract:

— the feature is 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.

Entities may have to use judgement in assessing whether lease payments indexed to a CPI contain leverage.

In our opinion, a leverage is observed when a coefficient > 1 is applied to the contractual inflation index (e.g. 1.5 x yearly CPI level for an instrument with yearly coupons).

— the feature is contingent rentals based on lessee related sales. This is because under IFRS 9, specified lessee volumes of sales is a non-financial variable specific to a party to the contract. Therefore, this feature does not meet the definition of an embedded derivative;

— Or the feature is contingent rentals based on variable interest rates.

13.3.5.6. The “closely-related” criterion – non-financial host contracts

13.3.5.6.1. Purchase / sale price denominated in a foreign currency

Purchase / sale contracts frequently contain foreign currency features, for instance where the purchase / sale price for the non-financial asset is denominated in a foreign currency.
IFRS 9.B4.3.8(d) indicates that such an embedded foreign currency derivative is closely related to the host contract provided it meets all of the 3 criteria:

— it is not leveraged;
— it does not contain an option feature; and
— it requires payments denominated in one of the following currencies:

> the functional currency of any substantial party to that contract;
> the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in (international) commercial transactions around the world (such as the US dollar for crude oil transactions);

– The “routinely” used currency cannot be a currency that is used for a certain product or service in commercial transactions only within the local area of one of the substantial parties to the contract.
– This is a currency that is used for similar transactions all around the world, not just in one local area.
– Example 13.24, based on paragraph IG.C.9 of IFRS 9, further illustrates this criterion.

> or a currency that is commonly used in contracts to purchase or sell non-financial items in the (primary) economic environment in which the transaction takes place and in which the party operates (e.g. a relatively stable and liquid currency that is commonly used in local business transactions or external trade). The basis for conclusions of IFRS 9 (IFRS 9.BCZ.4.94-95) provides some additional explanations on the rationale of this criterion:

– Entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or yen) instead of the local currency of any of the parties to the transaction.
– In addition, an entity operating in a hyperinflationary economy may use a price in a “hard” currency to protect against inflation (for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent).
– The IASB has therefore decided that a foreign currency derivative should be viewed as closely related to the host contract if that foreign currency is commonly used in local business transactions, for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of a relatively stable foreign currency, and prices may be quoted in that foreign currency.

We provide hereafter several examples on how the 3rd criterion relating to the “eligibility” of the contractual currency should be analysed.

Example 13.20

Consider a situation where the reporting entity, Entity A with US dollar as functional currency, enters into a contract to take delivery in one month of a collection of model dresses made of silk from a French manufacturer, Entity B with euro as functional currency. The purchase price will be paid in euros. The main elements to carry out the analysis of the 3rd criterion in IFRS 9.B4.3.8(d) are summarised hereafter:
> Entity A’s functional currency: US dollar
> Entity B’s functional currency: euro
> Contract currency: euro

This contract does not contain a foreign currency derivative requiring bifurcation because it is denominated in the functional currency of one of the parties.

Example 13.21

Now consider an example similar to the previous one but where the functional currency of the seller of the goods is not EUR. Suppose the same Entity A (the functional currency of which is the US Dollar) entered into a contract to take delivery of a collection of model dresses from Entity C, a British distributor the functional currency of which is GBP, for delivery in one month. The contract is denominated in euro. The main elements to carry out the analysis of the 3rd criterion in IFRS 9.B4.3.8(d) are summarised below:

> Entity A’s functional currency: US dollar
> Entity C’s functional currency: GB Pound
> Contract currency: euro

Here the foreign currency derivative is not closely related to the host purchase contract because (a) the payment is not denominated in either of the parties’ functional currencies, (b) model dresses sales contracts are not routinely denominated in EUR in (international) commercial transactions around the world and (c) EUR is not a currency that is commonly used in contracts to purchase or sell non-financial items in the (primary) economic environment of Entity A (i.e. neither of the 3 currency eligibility conditions in IFRS 9.B4.3.8(d) are met). Even though the British distributor must acquire the collection of model dresses made of silk from the German manufacturer in euros, the German manufacturer is not a party to the British distributor’s contract with Entity A.

Example 13.22

Consider another example where the contractual currency is not considered to be closely related to the host sale / purchase contract, based on an example in the Implementation Guidance of IFRS 9 (IFRS 9.IG.C.7).

A Norwegian entity, Entity D, agrees to sell oil to an entity in France, Entity F. The host oil contract is not within the scope of IFRS 9 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements (IFRS 9.2.4 and IFRS 9.BA.2) and the entity has not irrevocably designated it as measured at fair value through profit or loss in accordance with IFRS 9.2.5. The oil sale / purchase contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian krones are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contact as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in profit or loss, unless they designate this bifurcated derivative as a cash flow hedging instrument, if appropriate.

Example 13.23

Consider another example where the embedded currency-related provisions are not considered to be closely related to the host sale / purchase contract, based on an example in the Implementation Guidance of IFRS 9 (IFRS 9.IG.C.8).
Entity L, the functional currency of which is the euro, enters into a contract with Entity N, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of IFRS 9 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements (IFRS 9.2.4 and IFRS 9.BA.2) and the entity has not irrevocably designated it as measured at fair value through profit or loss in accordance with IFRS 9.2.5. The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars.

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity L’s nor Entity N’s functional currency. This foreign currency derivative would not be separated because it follows from paragraph IFRS 9.B4.3.8(d) that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is an addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under IFRS 9.4.3.3 (IFRS 9.IG.C.8).

**Example 13.24**

This example aims to illustrate the “globally routinely used currency” criterion in paragraph B4.3.8(d) of IFRS 9. It is based on the Implementation Guidance of IFRS 9 (IFRS 9.IG.C.9).

If cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

**13.3.5.6.2. Price caps and floors in sale / purchase contracts**

Similarly to the guidance applicable to interest rate caps or floors, IFRS 9.B4.3.8(b) indicates that provisions included in a contract to purchase or sell an asset (e.g. 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.

**Example 13.25**

Entity A enters into a long-term purchase contract for a specified quantity of commodity. The pricing terms call for the goods to be delivered at the then-current spot price but within a specified range. For instance, the goods must be sold at a price not lower than 37€ per ton and not higher than 75€ per ton, no matter what the current spot price might be. From the perspective of the entity A, this contract essentially contains two embedded options: a purchased call at 75€ per ton and a written put at 37€ per ton. However, these options, that are not leveraged, would not need to be bifurcated and accounted for separately if they are both out of the money at inception.
13.3.5.7. The “closely-related” criterion - insurance host contracts

IFRS 9 specifically states that part of the guidance on embedded derivatives already analysed above also applies to insurance host contracts, in particular principles for assessing:

- embedded indexations to floating interest rate (IFRS 9.B4.3.8(a) – see section 13.3.5.3.1);
- embedded caps and floors (IFRS 9.B4.3.8(b) – see section 13.3.5.3.2);
- embedded equity-indexation features (IFRS 9.B4.3.8(c) – see section 13.3.5.3.6);
- embedded commodity price indexation features (IFRS 9.B4.3.8(d) – see section 13.3.5.3.7);
- embedded calls and puts (IFRS 9.B4.3.8(e) – see section 13.3.5.3.9);
- embedded currency features (IFRS 9.B4.3.8(d) – see section 13.3.5.6.1).

IFRS 9 also contains two paragraphs dealing with insurance contract-specific embedded derivative issues.

13.3.5.7.1. Unit-linked contracts

A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

IFRS 9.B4.3.8(h) states that a unit-linking feature embedded in a host insurance contract or a host financial liability is closely related to the host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund.

13.3.5.7.2. The embedded feature and the host insurance contract are inter-dependent

IFRS 9.B4.3.8(h) indicates that 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 (i.e. without considering the host contract).

13.3.6. Bifurcating an embedded derivative

13.3.6.1. Splitting a hybrid contract into the host contract and a stand-alone derivative

The term “bifurcation” refers to the separation of the instrument into its components. A hybrid instrument contains a host contract and one or more embedded derivatives.

The general principle in IFRS 9 for the initial bifurcation is that:

- embedded derivatives are separated from their host contract on the basis of their stated (or implied substantive) terms; and
- the initial carrying amount of the host instrument is determined as the residual amount after separating the embedded derivative (IFRS 9.B4.3.3).
If, however, the entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative can be calculated indirectly as the difference between the fair value of the hybrid contract and the fair value of the host (IFRS 9.4.3.7).

If the entity is unable to measure the fair value of the embedded derivative indirectly (i.e. as the difference between the value of the hybrid contract and that of the host), the entire hybrid contract is designated as at fair value through profit or loss (IFRS 9.4.3.7).

This decision tree must be applied at each reporting date. If an entity is no longer able to determine the fair value of a bifurcated embedded derivative either directly or indirectly, the entire hybrid contract is designated as at fair value through profit or loss even if the entity did not do so previously (IFRS 9.4.3.6). This process relates, however, only to measurement issues. The assessment of whether an embedded derivative must be bifurcated is performed once for all upon initial recognition (see section 13.3.7).

IFRS 9 also includes specific guidance regarding the initial carrying amount of the embedded derivative component, depending on the optional (see section 13.3.6.3) or non-optional (see section 13.3.6.2) nature of the embedded derivative.

13.3.6.2. Separating an embedded non-option derivative

A non-option embedded derivative should be determined in a manner that results in its fair value being equal to zero at the initial recognition of the hybrid instrument (IFRS 9.B4.3.3).
This means, for example, that if the non-option embedded derivative has stated terms that are off-market at inception, the “off-market” component should be quantified and allocated to the host contract so that the derivative’s initial fair value will be equal to zero.

One situation where the terms of the embedded non-option derivative could be off-market is where the entity has contracted a hybrid instrument in a secondary market after the inception of this instrument. The general principle should still apply, meaning the terms of the embedded derivative at the initial recognition of the hybrid instrument should be determined by the entity in such a way as to result in the bifurcated embedded derivative having a fair value equal to zero.

The Implementation Guidance of IFRS 9 (IFRS 9.I.G.C.1) further details the principles for allocating contractual cash flows between the host contract and the embedded derivative in situations where the host contract is a financial liability which contains a non-option embedded derivative.

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid contract. In the absence of implied or stated terms, the entity makes its own judgement on the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid contract.

The entity cannot create a cash flow that does not exist. Artificial terms must not be created to introduce leverage, asymmetry, or some other risk exposure not already present in the hybrid instrument. If the appropriate terms for the non-option derivative are readily apparent (pursuant to documented legal terms), an entity cannot make its own judgement on these terms.

If entities were permitted to separate embedded non-option derivatives on other terms, a single hybrid contract could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid contract.

Entities should establish a notional amount and an underlying consistent with the terms of the hybrid instrument. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

The allocation of cash flows according to the requirements above may impact the financial statements in different ways:

— they determine the measurement of the separated derivative, and thus profit or loss of the entity (unless the derivative is documented as a hedge); and

— the cash flows attributed to the host contract will also impact financial statements via the requirements applicable to the host contract according to the relevant IFRS standard. For instance, if the host contract is a financial liability, the interest expense recorded in profit or loss will directly result from the portion of contractual cash flows attributed to the host contract.
Example 13.26

If this five-year debt instrument has fixed interest payments of CU40,000 annually and a contractual payment at maturity of CU1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays CU40,000 annually because there are no floating interest rate cash flows in the hybrid contract (IFRS 9.IG.C.1).

13.3.6.3. Separating an embedded option-based derivative

An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature (IFRS 9.B4.3.3). As a result, contrary to embedded non-optional derivatives, the embedded option-based derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract (IFRS 9.IG.C.2).

The economic behaviour of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid contract. Therefore, the separation of an option-based embedded derivative should be based on the stated terms of the option feature as stated in the contract. At the initial recognition of the contract embedded options could have a positive or negative fair value that includes both intrinsic value and time value (these notions are defined further in chapter 14).

13.3.6.4. Multiple embedded derivatives

Some hybrid contracts may contain more than one embedded derivative (e.g. a put or a call feature in addition to the cash flows being indexed to a specific underlying variable).

Generally, multiple embedded derivatives in a single hybrid contract are treated as a single compound embedded derivative (IFRS 9.B4.3.4).

However, separation of different embedded derivatives will be required in one of the following situations:

— embedded derivatives that are classified as equity according to IAS 32 are accounted for separately from other derivatives classified as assets or liabilities (see chapter 5); or

— if a hybrid contract has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other (IFRS 9.B4.3.4).

13.3.7. Reassessment of embedded derivatives

An entity should assess whether an embedded derivative should be separated from the host contract when the entity first becomes a party to the hybrid contract (IFRS 9.B4.3.11).

Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required (IFRS 9.B4.3.11).
If there is a modification of the contractual terms that significantly modifies the cash flows, the features embedded in the debt instrument according to its modified terms would have to be assessed for bifurcation by the issuer at the modification date.

An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

If there is no subsequent modification in the contractual cash flows, the conclusion on bifurcating or not the embedded derivative(s) reached at the initial recognition of the hybrid instrument will remain valid. This holds even in situations where, for example, market conditions change since the initial recognition date and considering these new market conditions would lead (supposing reassessment was permitted) to a different conclusion on whether the embedded derivative is closely related or not to the host contract. Should a reassessment be required even without a change in contractual terms, frequent monitoring of market conditions and other factors relevant for the assessment would be required (IFRS 9.BCZ.4.103). The prohibition to reassess embedded derivatives in such situations aims thus, among other things, at reducing the costs of implementing IFRS 9.

13.4. In-substance analysis of linked transactions and "synthetic instruments"

It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ("synthetic instrument" accounting) (IFRS 9.IG.C.6).

However, entities may enter into two or more legally separate transactions that, if combined, generate a result that is economically similar to entering into a single transaction. Depending on facts and circumstances, such operations may be requalified as being a derivative “in substance”. In such case the entity will have to account for a derivative under IFRS 9 rather than for several separate instruments.

The following indicators should be considered when assessing if separate transactions should be accounted for as one unit of account, in accordance with IFRS 9.IG.B.6:

- the transactions were entered into at the same time and in contemplation of one another;
- the transactions were executed with the same counterparty;
- the transactions relate to the same risk;
- there is no apparent economic need, or substantive business purpose, for structuring the transactions separately that could not also have been accomplished in a single transaction.

Conversely, the fact that each transaction has its own terms and conditions and each may be transferred or settled separately are indicators that the transactions have to be classified separately (IFRS 9.IG.C.6).
Determining whether two or more contracts should be combined is a matter of facts and circumstances requiring the use of professional judgement.

The accounting should follow the substance of the arrangements, especially if there is no apparent economic need or substantive business purpose for structuring a transaction.

In our opinion, even if the example provided by IFRS 9 is applied to a derivative transaction, the above analysis and related indicators provide guidance that is also relevant for any transactions involving non-derivative financial instruments.

Example 13.27

Let's consider an example with two offsetting loans. Entity A has granted a five-year fixed rate loan to another Entity B. Entity B has granted a five-year variable rate loan for the same amount to Entity A at the same time. The entities agreed that there will be no transfers of principal at inception of the two loans, since the entities have a netting agreement.

This combined transaction meets the definition of a derivative (i.e. there is an underlying variable, 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, and settlement at a future date, as per section 13.3.2). The contractual effect of the loans is the equivalent of an interest rate swap arrangement (see section 13.2.1.3.2) with no initial net investment.

The IASB noted that the same answer would apply even if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IFRS 9 does not require a net settlement.

Example 13.28

Let's assume a structured repo trade consisting of several transactions:

> Transaction 1 (bond purchase): Entity A purchases a bond (the bond) from another entity (Entity B).
> Transaction 2 (interest rate swap): Entity A enters into (an) interest rate swap contract(s) with Entity B. Entity A pays a fixed rate of interest equal to the fixed coupon rate of the purchased bond in Transaction 1 and receives a variable rate of interest.
> Transaction 3 (repurchase agreement): Entity A enters into a repurchase agreement with Entity B, in which Entity A sells the bond in Transaction 1 on the same day it purchases this bond from Entity B and agrees to buy back the bond at the maturity date of the bond.

This transaction was analysed by the IFRS Interpretations Committee in the March 2014 IFRIC Update. The Interpretations Committee noted that application of the guidance in IFRS 9.IG.B.6 requires judgement. It also noted that the indicators in IFRS 9.IG.B.6 may help an entity to determine the substance of the transaction, but that the presence or absence of any single specific indicator alone may not be conclusive.