

S02.04-SP-03-II.3

II - Complex Contracts: Procedure for classifying complex contracts

3. Contracts with an embedded derivative

Definition of an embedded derivative according to IFRS rules

(IFRS 9, par 4.3.1)

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.

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.

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, par 4.3.3)

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

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

(IFRS 9, par 4.3.4)

If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate IFRSs. This IFRS does not address whether an embedded derivative shall be presented separately in the statement of financial position.

Analysis of the qualification as an embedded derivative

Several indicators permit the detection of the presence of an embedded derivative:

- a. Contracts with renewal, cancellation or exit clauses under specific or indexed financial terms so that the use of the clause leads to booking a material revenue or expense item or leads to non-market conditions;
- b. Contracts for which the transaction currency is:
 - not the currency of the buyer;
 - not the currency of the seller;
 - not the customary currency of trade for the asset in international trades;
 - not the currency customarily used in the local economic environment or the customary currency for the asset in the region where the transaction is located.
- c. All the payment flows defined in the contracts contingent on market parameters (share price or indexes, exchange rate, raw materials price or index, etc.), not closely related to the purpose of the contract.

All the above indicators require a YES/NO answer + comments. This will lead to the conclusions regarding the qualification.

Examples

Chemical contract linked to oil prices

Solvay has a chemical contract that has prices linked to oil prices. Solvay believes that, from a qualitative perspective, the chemical product price is linked to the price of oil, as oil is a major input to the chemical process. A quantitative analysis reveals that oil are not directly correlated with chemical product prices.

Embedded derivative

Leasing contracts linked to inflation

A UK subsidiary leases a property in France. The rentals are paid in EUR linked to the rate of inflation in France.

No Embedded derivative

A UK subsidiary has a 10 years lease of a property in the UK with rental payments in GBP which increase at the rate of 1,5 times the change in UK RPI (Retail Price Index).

Embedded derivative: the factor of 1.5 is not justified by market conditions.

Contracts denominated in another currency

A French company orders an asset to a Swiss provider whose price is fixed to 10 000 kUSD. The order is signed the 01/01/N, the delivery of the asset is foreseen the 31/12/N. The payment will be made the day of the delivery.

Notes:

- The French company recognizes in EUR
- The Swiss Provider recognizes in CHF

Embedded derivative: the transaction currency (USD) is not currency of the buyer, nor the currency of the seller or the customary currency of trade for this kind of asset.

Embedded derivative closely related to the host contract

Solvay buys Methyl Chloroform to the supplier X. The price is indexed on the Ethylene price and Ethylene is one raw material used for the production of Methyl Chloroform.

Embedded derivative closely related to the host contract: this contract doesn't need to be reported as a complex one as no specific accounting treatment is needed.