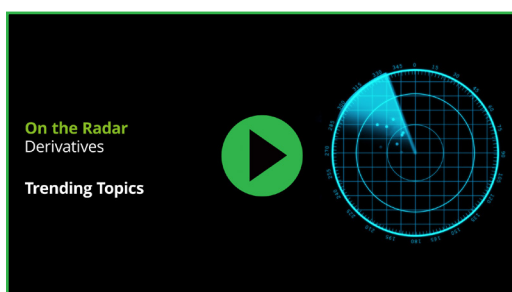




On the Radar Derivatives

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



Financial Reporting Considerations

What is a derivative?

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

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

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

Underlying, notional amount, payment provision	The contract contains both (1) “[o]ne or more underlyings” and (2) “[o]ne or more notional amounts or payment provisions or both.”
Initial net investment	“The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.”
Net settlement	“The contract can be settled net by any of the following means: <ol style="list-style-type: none">1. Its terms implicitly or explicitly require or permit net settlement.2. It can readily be settled net by a means outside the contract.3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.”

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

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

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

What is an embedded derivative?

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

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

Not clearly and closely related	“The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.”
Hybrid instrument not measured at fair value on a recurring basis	“The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.”
Meets the definition of a derivative	“A separate [freestanding] instrument with the same terms as the embedded derivative” would meet the definition of a derivative and would not qualify for a derivative scope exception.

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

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

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

How are derivatives measured and recognized?

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

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

Standard-Setting Activity

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

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

On September 29, 2025, the FASB issued [ASU 2025-07](#) which (1) refines the scope of the guidance on derivatives in ASC 815 and (2) clarifies the guidance on share-based payments from a customer in ASC 606. The ASU is intended to address concerns about the application of derivative accounting to contracts that have features based on the operations or activities of one of the parties to the contract and to reduce diversity in the accounting for share-based payments in revenue contracts.

The ASU adds a new scope exception in ASC 815-10-15-59(e) for certain contracts that are not traded on an exchange and have “[a]n underlying that is based on operations or activities specific to one of the parties to the contract.” Contracts that may qualify for this exception include those in which the underlying is linked to the “occurrence or nonoccurrence of an event,” such as achieving specified financial operating results or environmental, social, and governance (ESG) metrics, obtaining regulatory approval, or reaching specified product development milestones. In addition, the scope exception may apply to certain R&D funding arrangements as well as certain litigation funding arrangements.

The ASU also clarifies that when an entity has a right to receive a share-based payment from its customer in exchange for the transfer of goods or services, the share-based payment should be accounted for as noncash consideration within the scope of ASC 606. That is, the ASU specifies that the guidance in ASC 815 or ASC 321 does not apply to share-based payments from a customer “unless and until the entity's right to receive or retain the share-based noncash consideration is unconditional” in accordance with ASC 606. ASC 606-10-45-4 states that a “right to consideration is unconditional if only the passage of time is required before payment of that consideration is due.”

ASU 2025-07 is effective for annual reporting periods beginning after December 15, 2026, including interim reporting periods within those annual reporting periods. Early adoption of the standard is permitted in an interim or annual reporting period for which financial statements have not been issued or made available for issuance. If an entity elects to early adopt the standard in an interim period, the entity must apply the standard as of the beginning of the fiscal year that includes the interim period. Further, an entity that elects to early adopt the ASU is required to early adopt the guidance for both Issue 1 and Issue 2 in the standard.

For more information about the ASU, see Deloitte's September 29, 2025, [Heads Up](#).

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

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