

Watch out for Embedded Derivatives

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Earlier this year a CEO of one company told me how well his business was doing on the top line but expressed his disappointment with the adverse impact on profitability of a loss on a derivative instrument, which he was initially not aware of. Under Tanzania Financial Accounting Standards (TFAS), the exposure on the instrument was off-balance sheet and therefore any gains or losses were not recognised on the income statement. The losses started to show up when the company converted to International Financial Reporting Standards (IFRSs) and recognised the exposure on balance sheet in line with the recognition requirements of IAS 39. A number of other companies have probably not yet realised their exposure to similar adjustments.

A few years ago, many people were scared when the word derivative was mentioned. Indeed, most executives preferred to simply stay away from any derivative transaction either because of their lack of understanding or knowledge of derivatives or because of the bad reputation derivatives had acquired due to speculators who burnt their fingers when they used these instruments in risky transactions with a view of reaping huge profits. Of particular concern was that many companies took exposures they did not fully understand or test, resulting into huge derivative losses. Nevertheless, with the increase in the general understanding of derivatives and the improvement in risk management procedures, derivatives have now gained substantial popularity and are widely used today. Identification can prove a challenge, however, as certain derivatives, which are embedded in normal contracts, are difficult to find and may easily skip the attention of management from both accounting and risk management perspectives.

What are derivatives?

Paragraph 9 of IAS 39 gives a definition of a derivative. This definition indicates that a derivative is a contract that has all of the following features:

- Its value changes in response to an underlying such as interest rate, security price, commodity price, foreign exchange rate etc;
- It requires little or no initial net investment; and
- It is settled at a future date.

In simple terms, a derivative can therefore be said to be a financial contract whose value depends on the values of one or more underlying. Common derivative contracts are forwards, swaps, futures, and options, which can be entered in a simple form or can be included in complex financing structures. The use of simple or “plain-vanilla” derivatives such as forwards and swaps has started to gain popularity among financial institutions in Tanzania. In addition complex structures have occasionally been used, especially in relation to funding structured from overseas.

What are embedded derivatives?

IAS 39 defines an embedded derivative as a component of a hybrid (combined) instrument that also includes a non-derivative host contract - 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 is therefore a derivative instrument that is embedded in another contract, which is known as “the host contract”. The host contract might be a debt or equity instrument, a lease, an insurance contract, normal sale or purchase contract, services agreements, loan agreements etc.

Embedded derivatives are common and many companies use them on a daily basis, sometimes without their knowledge. A good example in Tanzania is the regular use of embedded foreign currency derivatives. In terms of IAS 39, an embedded foreign currency derivative arises whenever two companies enter into a sale and purchase contract in a currency that is not the functional currency or a commonly used currency of any of the parties to the contract. For example, if an exporter of coffee from Tanzania to a company in Germany invoices his counterparty in US Dollars, there is an embedded foreign currency derivative in US Dollars, which, based on the rules described below, may need to be separately accounted for. Most importers and exporters in Tanzania transact business through currencies that are not functional currencies in Tanzania, which may result in embedded derivatives.

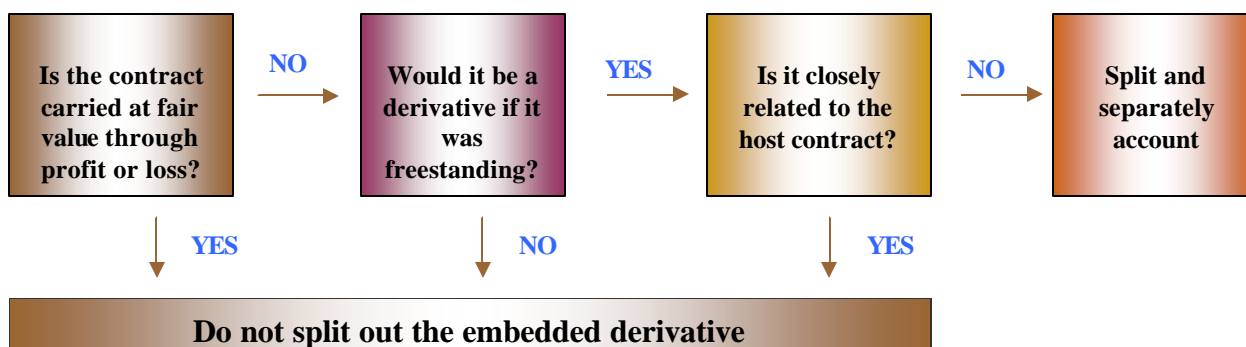
Accounting requirements

IAS 39 requires that all derivatives must be recognised at fair value. For this reason, derivatives that are embedded in normal contracts need to be separated and accounted for at fair value. The requirement to separate embedded derivatives is designed to ensure that the fair value of derivatives through profit or loss cannot be avoided by simply including or embedding a derivative in another contract that itself is not carried at fair value through profit or loss.

However, not all embedded derivatives need to be separated. An embedded derivative is separated from the host contract and accounted for separately if:

- the entire contract is not carried at fair value through profit or loss;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- its economic characteristics are not 'closely related' to those of the host contract.

The above is demonstrated by the following decision tree:



IAS 39 does not provide extensive guidance on what 'closely related' means. However it provides a number of illustrative examples.

In determining the fair value of an embedded derivative, published price quotations in an active market are normally the best evidence of fair value. Valuation techniques are used to determine the fair value of the derivative if there is no active market that matches the exact terms of the embedded derivative.

Valuation techniques are presumed to be available for almost all embedded derivatives. IAS 39 requires the entire contract (i.e. the host contract and the embedded derivative) to be fair valued if an embedded derivative cannot be fair valued separately.

What should companies do?

Everyone needs to appreciate that embedded derivatives are very prevalent and that their impact on financial statements could be material. Against this background, companies need to take the following steps:

- (a) Review all outstanding contracts for possible embedded derivatives;
- (b) Determine whether embedded derivatives need to be accounted for separately;
- (c) Where necessary, modify systems to develop valuation capabilities, to track changes in fair value of financial instruments, to process the required accounting entries and to generate the necessary information required for disclosure purposes. Companies that are thinking of acquiring new accounting systems should make sure that such systems are able to process and generate information needed to comply with IAS 39 and other IFRSs;
- (d) Document risk management strategies and valuation policies; and
- (e) Identify and document objectives in holding or issuing derivatives.

Conclusion

This paper sets out the key requirements of IAS 39 relating to embedded derivatives, and does not specifically deal with issues surrounding conversion from TFAS to IFRS, which may need further guidance. Given that embedded derivatives are so common, companies would be unwise to simply assume that they do not have derivatives. Instead they should recognise the need for a review of their contracts for possible derivatives that may need to be accounted for separately. The valuation of these derivatives using valuation techniques may prove to be challenging. For any question or need of guidance, please contact the author of the paper at the following email address:
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