UNIT 5:
DERIVATIVES AND EMBEDDED DERIVATIVES

5.1 INTRODUCTION

Derivatives may exist as standalone financial instruments or may be embedded in other financial or non-financial instruments.

In Unit 2 of this chapter, we analysed the definitions of financial liability and equity. Both these definitions envisage situations in which an instrument is settled by exchange of own equity instruments which are derivatives. To be specific, let’s reproduce the relevant portion of these definitions and set the context of discussion for this paragraph in terms of this situation.

**Financial liability**

A financial instrument that fulfils either of (A) or (B) below:

(A) …..

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i) …..

(ii) **a derivative** that will or may be settled **other than by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

**Equity**

A financial instrument that fulfils both (A) and (B) below:

(A) …..

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i) …..

(ii) **a derivative** that will or may be settled **only by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

5.2 DEFINITION

5.2.1 Derivatives

Ind AS 109.Appendix A defines a derivative as a financial instrument or other contract with all of the following three characteristics:
i. **Value changes due to an underlying**: its value changes in response to the change in 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 (sometimes called the 'underlying');

Examples of common derivative contracts and the identified underlying variable:

<table>
<thead>
<tr>
<th>Type of contract</th>
<th>Main pricing-settlement variable (underlying variable)</th>
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<td>Interest rate swap</td>
<td>Interest rates</td>
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<td>Currency swap (foreign exchange swap)</td>
<td>Currency rates</td>
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<td>Commodity swap</td>
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<td>Equity swap</td>
<td>Equity prices (equity of another entity)</td>
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<td>Credit swap</td>
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<td>Total return swap</td>
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<td>Purchased or written treasury bond option (call or put)</td>
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<td>Currency rates</td>
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<td>Purchased or written commodity option (call or put)</td>
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<td>Interest rate futures linked to government debt (treasury futures)</td>
<td>Interest rates</td>
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<tr>
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<tr>
<td>Commodity forward</td>
<td>Commodity prices</td>
</tr>
<tr>
<td>Equity forward</td>
<td>Equity prices (equity of another entity)</td>
</tr>
</tbody>
</table>

The definition of derivative excludes contracts which fulfil following two conditions:

- Value of the contract changes with reference to one or more non-financial variables; and
- That non-financial variable is specific to one of the parties to the contract.
As per paragraph BA.5 of Ind AS 109, a change in the fair value of a non-financial asset is specific to the owner if 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).

Examples of non-financial variables that are not specific to a party to the contract are an index of earthquake losses in a particular region and an index of temperatures in a particular city.

Non-financial variables specific to a party to the contract include:

- the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract
- residual value of an asset which changes in response to changes in the asset’s physical condition

Derivatives give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. Because the terms of the exchange are determined at inception, as prices in the financial markets change, those terms may become favourable or unfavourable.

A derivative usually has a notional amount, which can be an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. The changes in value of a derivative are measured corresponding to the notional amount. Refer illustration 1 and 2 below.

ii. **No or little initial net investment**: 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.

**Illustration 1: Prepaid interest rate swap (fixed rate payment obligation prepaid at inception)**

Entity S enters into a ₹ 100 crores notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C.

- The interest rate of the variable part of the swap is reset on a quarterly basis to three-month Mumbai Interbank Offer Rate (MIBOR).
- The interest rate of the fixed part of the swap is 10% p.a.
- Entity S prepays its fixed obligation under the swap of ₹ 50 crores (₹ 100 crores × 10% × 5 years) at inception, discounted using market interest rates.
- Entity S retains the right to receive interest payments on the ₹ 100 crores reset quarterly based on three-month MIBOR over the life of the swap.

Analyse.
Solution

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 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 condition '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'.

Even though Entity S 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 regarded as a derivative contract.

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Illustration 2: Prepaid pay-variable, receive-fixed interest rate swap

♦ Entity S enters into a ₹100 crores notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C.
♦ The variable leg of the swap is reset on a quarterly basis to three-month MIBOR.
♦ The fixed interest payments under the swap are calculated as 10% of the swap's notional amount, i.e. ₹10 crores p.a.
♦ Entity S prepays its obligation under the variable leg of the swap at inception at current market rates. Say, that amount is ₹36 crores.
♦ It retains the right to receive fixed interest payments of 10% on ₹100 crores every year.

Analyse.

Solution

In effect, this contract results in an initial net investment of ₹36 crores which yields a cash inflow of ₹10 crores every year, for five years. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

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 in the pay-variable, receive-fixed 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 condition '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'. Therefore, the contract is not accounted for as a derivative contract.

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Illustration 3: Prepaid forward

Entity XYZ enters into a forward contract to purchase 1 million ordinary shares of Entity T in one year

- The current market price of T is ₹50 per share
- The one-year forward price of T is ₹55 per share
- XYZ is required to prepay the forward contract at inception with a ₹50 million payment.

Analyse.

Solution

Purchase of 1 million shares for current market price is likely to have the same response to changes in market factors as the contract mentioned above. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

Future settlement: it is settled at a future date.

However, it is not relevant whether the derivative is settled gross or not. For example, an interest rate swap is a derivative instrument, whether the counterparties pay interest to each other or settle it on a net basis.

Further, an option, say a call option i.e. a right to purchase shares at a fixed price at a certain date in future, may expire unexercised at maturity because it is ‘out of money’. Such a contract is still a derivative contract because expiry at maturity is also a form of settlement even though there is no exchange of consideration eventually.

5.2.2 Embedded derivatives

Paragraph 4.3.1 of Ind AS 109 defines an embedded derivative as:

"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."

### 5.2.2.1 Separation of embedded derivatives from host contract

In certain circumstances, an embedded derivative is required to be separated from the host contract and accounted for separately as a financial instrument. The flowchart below analyses those circumstances:

Does the hybrid contract contain a host that is an asset within the scope of Ind AS 109?

- No – separate embedded derivatives that fulfil certain conditions as below
- Yes – don’t separate embedded derivatives (Refer note 1 below)

Economic characteristics and risks of the embedded derivative are closely related to those of the host?

- No
- Yes

A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative?

- No
- Yes

Is the hybrid contract measured at fair value through profit or loss?

- No
- Yes

Embedded derivative is separated and accounted for separately (refer section below)
Note 1: This implies that embedded derivatives are permitted to be separated from only such hybrid contracts that contain a host which is either a (a) financial instrument classified as financial liability or equity or compound; or (b) contract for purchase or sale of a non-financial item.

Note 2: If both the host and embedded derivative have economic characteristics of an equity instrument, the hybrid instrument is not carried at fair value through profit or loss. In other words, this measurement category is applicable only for host contracts which are financial liabilities.

5.2.2.2 Economic characteristics and risks of the embedded derivative – whether closely related to those of the host?

Paragraphs B4.3.5 and B4.3.8 of Ind AS 109 provide examples of situations in which economic characteristics of the embedded derivative are considered to be closely related or not closely related to those of the host.

Some of these examples are explained below, though students are advised to understand all the examples given in the application guidance of the standards.

1. **Underlying indices**

   **Illustration 4: Debt instrument with indexed repayments**

   *Entity X issues a redeemable fixed interest rate debenture to Entity Y. Amount of interest and principal is indexed to the value of equity instruments of Entity X*

   **Analyse**

   **Solution**

   In the given case, the host is a fixed interest rate debt instrument. The economic characteristics and risks of a debt instrument are not closely related to those of an equity instrument.

   Hence, the exposure of this hybrid instrument to changes in value of equity instruments is an embedded derivative which is required to be separated.

   The response above will not change even if the interest payment and principal repayments are indexed to a commodity index or similar underlying.

2. **Prepayment options in debt instruments**

   It is very common to have debt prepayment options in ordinary borrowing arrangements. Paragraph B4.3.5(e) of Ind AS 109 provides the guidance in this respect:

   “A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:"

   i. the option’s exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract;
or

ii. the exercise price of a 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 Ind AS 32."

Ind AS 109 does not interpret the term “approximately equal”. Management of entities will need to adopt a consistent accounting policy to apply this principle in general.

Illustration 5: Debt instrument with prepayment option

Entity PQR borrows ₹100 crores from CFDH Bank on 1 April 20X1.
Interest is payable at 12% p.a. and there is a bullet repayment of principal at the end of the term.
Term of the loan is 6 years.
The loan includes an option to prepay the loan at 1st April each year with a prepayment penalty of 3%.
There are no transaction costs.
Without the prepayment option, the interest rate quoted by bank is 11% p.a.

Analyse

Solution

Step 1: Identify the host contract and embedded derivative, if any

In the given case,

- Host is a debt instrument comprising annual interest payment at 12% p.a. and bullet principal repayment at the end of 6 years.
- Option to prepay the debt at ₹ 103 crores is an embedded derivative

Step 2: Determine the amortised cost of the host debt instrument

Whether the prepayment option is likely to be exercised or not, the amortised cost of the host debt instrument should be calculated as present value (PV) of expected cash flows using a fair market interest rate for a debt without the prepayment option (11% p.a. in this case). This is calculated below as ₹ 104.23 crores:
### Step 3: Compare the exercise price of the prepayment option with the amortised cost of the host debt instrument

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortised cost</th>
<th>Exercise price of prepayment option</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>₹ Crores</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>103.68</td>
<td>103.00</td>
<td>0.7%</td>
</tr>
<tr>
<td>2</td>
<td>103.09</td>
<td>103.00</td>
<td>0.1%</td>
</tr>
<tr>
<td>3</td>
<td>102.43</td>
<td>103.00</td>
<td>-0.6%</td>
</tr>
<tr>
<td>4</td>
<td>101.70</td>
<td>103.00</td>
<td>-1.3%</td>
</tr>
<tr>
<td>5</td>
<td>100.90</td>
<td>103.00</td>
<td>-2.1%</td>
</tr>
<tr>
<td>6</td>
<td>-</td>
<td>N/A</td>
<td></td>
</tr>
</tbody>
</table>

The management of Entity PQR may formulate an appropriate accounting policy to determine what constitutes “approximately equal”. In this case, if the management determines that a difference of more than 2% will indicate that the option's exercise price is not approximately equal to the amortised cost of the host debt instrument, it will need to separate the embedded derivative and account for it as per principles given in the subsequent sub-section.

It may be questioned as to why an option to repay a fixed rate loan early meets the definition of embedded derivative. Let us revisit an important phrase from the definition of embedded derivative:

“…some or all of the cash flows that otherwise would be required by the contract to be modified…”

In the context of a fixed rate debt, it may be interpreted that:

- the option affects cash flows only if exercised; and
- the cash flows of a fixed rate debt do not vary with interest rates.
However, in this context, a variation in cash flows should be interpreted as a possible change in the fair value of expected cash flows. Accordingly, the option's expected cash flows vary according to interest rates in a similar way as a separate option to purchase a fixed rate debt asset at a fixed price. A fixed price option to prepay a fixed rate loan will increase in value as interest rates decline (and vice versa).

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3. **Foreign currency derivative embedded in contract for purchase or sale of non-financial items**

Another common situation in trade and commerce in today’s world is a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency. Paragraph B4.3.8(d) provides following guidance in this respect.

“An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

i. the functional currency of any substantial party to that contract;

ii. the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

iii. a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).”

The functional currencies of the parties should be determined in accordance with the definition and guidance in Ind AS 21.9 to 13.

Unless the above exceptions apply, the embedded foreign currency derivative should be separated from the host contract. Certain guidance on how to carry out the separation are enumerated below in detail:

1. the host contract is a sale or purchase contract denominated in the functional currency of the reporting entity

2. the amount of functional currency is determined using the relevant forward exchange rate (to the date of delivery) at the date the contract is entered into

3. the embedded derivative is a forward currency contract to buy or sell the applicable amount of the contract currency for the functional currency, at the same forward exchange rate. The effect is that the fair value of the embedded derivative is initially zero

4. subsequent changes in the fair value of the embedded derivative are recorded in profit or loss
5. On delivery of the non-financial item, the host contract is fulfilled and the embedded derivative is effectively settled. A foreign currency debtor or creditor is recognised for the contract amount, translated at the spot rate in accordance with Ind AS 21.23(a). The closing carrying amount of the embedded derivative is added to the functional currency amount of the host contract to give the initial carrying amount of the debtor or creditor.

Illustration 6: Purchase contract settled in a foreign currency

On 1 January 20X1, ABG Pvt. Ltd., a company incorporated in India enters into a contract to buy solar panels from A&A Associates, a firm domiciled in UAE, for which delivery is due after 6 months i.e. on 30 June 20X1.

The purchase price for solar panels is US$ 50 million.

The functional currency of ABG is Indian Rupees (INR) and of A&A is Dirhams.

The obligation to settle the contract in US Dollars has been evaluated to be an embedded derivative which is not closely related to the host purchase contract.

Exchange rates:
1. Spot rate on 1 January 20X1: USD 1 = INR 60
2. Six-month forward rate on 1 January 20X1: USD 1 = INR 65
3. Spot rate on 30 June 20X1: USD 1 = INR 66

Analyse

Solution

This contract comprises of two components:

- Host contract to purchase solar panels denominated in INR i.e. a notional payment in INR at 6-month forward rate (INR 3,250 million or INR 325 crores)
- Forward contract to pay US Dollars and receive INR i.e. a notional receipt in INR. In other words, a forward contract to sell US Dollars at INR 65 per US Dollar

It may be noted that the notional INR payment in respect of host contract and the notional INR receipt in respect of embedded derivative create an offsetting position.

Subsequently, the host contract is not accounted for until delivery. The embedded derivative is recorded at fair value through profit or loss. This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

On delivery ABG records the inventory at the amount of the host contract (INR 325 crores). The embedded derivative is considered to expire. The derivative asset or liability (i.e. the cumulative gain or loss) is settled by becoming part of the financial liability that arises on delivery.
In this case the carrying value of the currency forward at 30 June 20X1 on maturity is INR 50 million \( \times (66 \text{ minus } 65) = \) INR 5 crores (liability/loss). The loss arises because ABG has agreed to sell US Dollars at ₹ 65 per US Dollar whereas in the open market, US Dollar can be sold at ₹ 66 per US Dollar.

No accounting entries are passed on the date of entering into purchase contract. On that date, the forward contract has a fair value of zero (refer section “option and non-option based derivatives” below)

Subsequently, say at 30 June 20X1, the accounting entries are as follows (all in INR crores):

1. Loss on derivative contract 5  
   To Derivative liability 5  
   (Being loss on currency forward)

2. Inventory 325  
   To Trade payables (financial liability) 325  
   (Being inventory recorded at forward exchange rate determined on date of contract)

3. Derivative liability 5  
   To Trade payables (financial liability) 5  
   (Being reclassification of derivative liability to trade payables upon settlement)

The effect is that the financial liability at the date of delivery is INR 330 crores (\( = \) INR 325 crores + INR 5 crores), equivalent to US$ 50 million at the spot rate on 30 June 20X1.

Going forward, the financial liability is a US$ denominated financial instrument. It is retranslated at the dollar spot rate in the normal way, until it is settled.

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4. Option and non-option based derivatives

A. Non-option based derivatives

The terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid contract. Non-option based derivatives represent obligations of the counterparties to a contract.

Fair value of a financial instrument is a combination of its intrinsic value and time value. In a fair and perfect market, it would be inappropriate to conclude that immediately at the inception of a contract, it results in creation of rights and obligations for two independent parties i.e. the contract has no intrinsic value at inception. Also, the time value starts accumulating only after the first day of the contract.
The standard specifies that if it 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. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid contract.

Further, in the case of non-option based derivatives, terms of the host debt instrument reflect the (a) stated or (b) implied substantive terms of the hybrid contract. In the absence of implied or stated terms, the entity makes its own judgement of the terms.

B. Option based derivatives

The economic behaviour of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or exercise price) specified for the option feature in the hybrid contract. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caption, floortion or swaption feature in a hybrid contract) should be based on the stated terms of the option feature documented in the hybrid contract (unlike a non-option based derivative which is separated on the basis of implied terms also). As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid contract being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid contract to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid contract. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid contract, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price of the underlying variable at the initial recognition of the hybrid contract.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of
an option-based embedded derivative, therefore, alters the nature of the hybrid contract. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid contract, that amount would essentially represent a borrowing or lending. Accordingly, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid contract.

### 5.2.2.3 Accounting for embedded derivatives

If the flowchart given in paragraph “Separation of embedded derivatives” results in the conclusion that the embedded derivatives are required to be separated, an entity shall measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss. [Paragraph 4.3.4 of Ind AS 109]

The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative. [Paragraph B4.3.3 of Ind AS 109]

As per paragraph 4.3.5 of Ind AS 109, if a contract contains one or more embedded derivatives and the host is not a financial asset, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

i. the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or

ii. it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

These are two exceptions to the general principle that hybrid contracts can be measured at fair value in their entirety, without separation of embedded derivatives. Refer explanation below Illustration 5 for interpretation of the phrase “significantly modify cash flows” mentioned above.

Further, as per paragraph 4.3.6 of Ind AS 109, if an entity is required to separate an embedded derivative from its host (as per flowchart presented earlier in this paragraph), but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.

If an 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 is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the embedded derivative using this method, the hybrid contract is designated as at fair value through profit or loss.

To conclude, picking up from the flowchart presented earlier in this paragraph, the accounting implications are demonstrated in the flow chart below:
Is the hybrid contract designated at fair value through profit or loss in its entirety (paragraph 4.3.5 of Ind AS 109)?

- No
  - Can the fair value of embedded derivative be measured reliably?
    - Yes
      - Measure embedded derivative and allocate residual to host
    - No
      - Is the entity able to measure the fair value of the hybrid contract?
        - Yes
          - Is the entity able to measure the fair value of the host contract?
            - Yes
              - Entire hybrid instrument is measured at fair value through profit or loss
            - No
              - Fair value of embedded derivative = Fair value of hybrid contract minus fair value of host contract
        - No
          - Don’t separate embedded derivatives