Fair Value Mechanism, Derivatives and Hedging

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New IFRS

When an entity has not applied a new IFRS that has been issued but is not yet effective, the entity shall disclose:

(a) this fact; and

(b) known or reasonably estimable information relevant to assessing the possible impact that application of the new IFRS will have on the entity's financial statements in the period of initial application. (IAS 8.30)

IAS 32, 39,IFRS 9

Definition of Fair Value

- **Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. (IAS 32.7)

Financial Instrument

A ***financial instrument*** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Fair Value Measurement Considerations under IAS 39

- Relevant Paragraphs
  - IAS 39.48 and 39.49
  - IAS 39 AG 69 to AG 82

IAS 39 sets out the principles for determining the fair value of financial instruments addressing three key areas:

- An active market with quoted prices
- No active market: valuation technique
- No active market: equity instruments

Fair Value to reflect Credit Quality

- For instruments traded in an open market, this is likely to be incorporated in the price
- In case of over-the-counter derivatives, the standard approach is to value the derivative using the AA rated curve in the valuation model
- While in case of others, the market quoted rates used in the valuation model should be adjusted for credit risk
- Any changes in the credit quality will need to be considered when re-measuring fair value

Accounting for Impairment Loss of Financial Instruments

- If there is an evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as the
- difference between
- the asset's carrying amount and the present value of estimated future cash flows
- discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition).

Accounting for Impairment Loss of Financial Instruments

- The carrying amount of the asset shall be reduced either directly or through use of an allowance account.
- The amount of the loss shall be recognised in profit or loss. (Para 63)

Fair Value Hedge

- A hedge of the exposure to changes in fair value of:
  a) a recognised asset, liability or an unrecognised firm commitment or
  b) an identified portion of an asset, a liability or a firm commitment that are attributable to a particular risk and could affect profit or loss
- Examples of hedged items in a fair value hedge:
  - fixed-rate debt
  - fixed-rate receivables
  - equity instruments, or inventory

Accounting for Gain or Loss on Hedge Instruments

Hedging Instrument

- The gain or loss from re-measuring the hedging instrument at fair value is recognised in profit or loss as it arises

Hedged Item

- The carrying amount of the hedged item is adjusted through profit or loss for the corresponding gain or loss attributable to the hedged risk

IFRS 13 Fair Value Measurement

Paras

Appendix

Fair Value (IFRS 13)

Fair Value –

- It is a price –
- received when an **asset is sold** or paid to **transfer a liability**
- in an orderly transaction between participants
- at the measurement date.

(Appendix A)

Orderly Transaction

A transaction that

- assumes exposure to the market
- for a period before the measurement date
- to allow for marketing activities
- that are usual and customary for transactions
- involving such assets or liabilities;
- it is not a forced transaction (e.g., a forced liquidation or distress sale) (Appendix A of IFRS 13)

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

(a) They are independent of each other,

(b) They are knowledgeable,

(c) They are able to enter into a transaction for the asset or liability.

(d) They are willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.

Most Advantageous Market

The market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

IFRS 13 Fair Value Measurement

IFRS 13

Definition
of
FAIR VALUE

Framework
for
measuring
FAIR VALUE

Disclosures
about
FAIR VALUE
MEASUREMENTS

Under Fair Value measurement
the transactions
are said to take place
in the most advantageous markets or
principle market

Fair value measurement

is

based on the

market and not entity specific

Asset or Liability

A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value an entity shall take into account the

- characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the
- measurement date.

Asset or Liability

Such characteristics include, for example, the following:

- (a) the condition and location of the asset; and
- (b) restrictions, if any, on the sale or use of the asset

Asset or Liability

- The asset or liability measured at fair value might be either of the following:

(a) a stand-alone asset or liability (eg a financial instrument or a non-financial asset); or

(b) a group of assets, a group of liabilities or a group of assets and liabilities (eg a cash-generating unit or a business).

Non Financial Assets

- In case of non –financial assets, fair value is measured based on the **highest and best use** of the asset according to the market conditions

Entity’s Intention is Irrelevant in FVM

An entity’s intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value

Derivatives and Hedging

Definition of a Derivative

IFRS
Derivative is a contract: • whose value changes in response to an underlying; • which requires little or no initial net investment; and • which settles at a future date

IAS 39 scopes out lease contracts and contracts for “own use” but these contracts may contain embedded derivatives

Derivatives

- A derivatives is one that has all of the following characteristics
  - Value changes in response to the change in an “underlying” instrument.
  - Minimal or no initial net investment is required.
  - Settled at a future date -
does not depend on gross or net settlement

Complying
all
3 conditions
is essential

Derivatives–Common Principles

- Derivatives must meet the definition of an asset or liability
- Fair value is the only relevant measure
- Embedded derivatives must be bifurcated if:
  - Not closely related
  - Hybrid not Mark-To-Market through income statement
  - Meets definition of a derivative
- Hedge accounting in limited circumstances

Example on Derivative

Company X enters into a contract with Company B that permits it to acquire the 1,000,000 shares of Company C (a non-listed company) for Rupees 10 million at December 31, 2010.

Company X does not expect that it will acquire the shares in the future.

Example on Derivative

- **Underlying** –Security price of Company C
- **Notional**–Rupees 10 million
- **Initial net investment**– Zero or none
- **Future settlement**–Explicit through the payment provision in exchange for the shares

Is it a Derivative under IAS 39? : Yes

Derivatives on Own Shares

- Net share settled derivatives on own equity are always accounted for as derivatives at fair value under IAS 32/IAS 39
- Derivatives on own equity for which the entity has the option to settle gross in own shares are accounted for as derivatives at fair value if either the issuer or the counterparty can elect net settlement

Hedge Accounting

General Definition on Hedge

- **A hedge** or **hedgerow** is a line of closely spaced shrubs and tree species, planted and trained in such a way as to form a barrier or to mark the boundary of an area. Hedges used to separate a road from adjoining fields or one field from another, and of sufficient age to incorporate larger trees, are known as hedgerows. It is also a simple form of topiary.
- A **hedge** is a mitigating device used to lessen the impact of an utterance.
- Hedging is about managing risk (ERM)

Hedging

- IAS 39.71

  If there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 85–88 and Appendix A paragraphs AG102–AG104, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 89–102.

Hedging Relationships (IAS 39.85-88)

- IAS 39.85-88
- IAS 39.86

Hedging relationships are of Three Types

1. *fair value hedge*
2. *cash flow hedge*
3. *hedge of a net investment in a foreign operation* as defined in IAS 21.

Hedging Conditions - IAS 39.88

A hedging relationship qualifies for hedge accounting only if, all of the following conditions are met

1. At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.

Hedging Conditions

2. The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship

Hedging Conditions

3. For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

Hedging Conditions

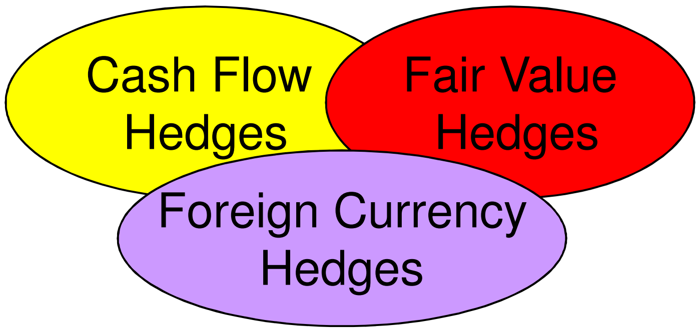
4. The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured

Hedging

5. The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Hedge accounting

- Hedge accounting is elective and strict qualification criteria
  - Documentation
  - Hedge effectiveness assessment and measurement



Hedging

Hedge Designation and Documentation

- Type of hedge–fair value hedging
  - cash flow hedging,
  - Foreign currency net investment
- Management objective
- Nature of risk being hedge
- Identification of hedging instrument and hedge item
- Both prospective and retrospective assessment of effectiveness

Hedging under IFRS

- Under IFRS, a company can hedge a portion of the cash flows or fair value (e.g. percent of Libor interest payments)
- For financial items the risks that can be hedged are not limited under IFRS, as long as effectiveness can be measured.
  - **No requirement under IFRS that hedged interest rate risk must be a “benchmark” interest rate.**
  - Allows entities to hedge components (portions) that give rise to changes in fair value
  - Should be predictable and separately measurable

Hedge Items under IFRS

Under IFRS,

- Companies can hedge forecasted business combinations subject to foreign exchange risk
- Partial term hedges can be done (e.g., fair value hedge for first 3 years of a 5-year fixed rate bond);
- Special portfolio hedging rules exist for interest rate risk

Hedging Instruments under IFRS

IFRS

- Permits a derivative to be separated and designated in two or more hedges pertaining to different risks
- The written options cannot be used as hedging instruments unless hedged item has opposite optionality.
- Permits a non-derivative financial instrument to be used as a hedging instrument for any hedge relationship, as long as criteria are met.
- Under IFRS, only instruments with external parties can be used.
- In order to achieve “perfect effectiveness,” time value of option is excluded in hedge effectiveness assessment under IFRS and cannot assume optionality in a hedged item.

Assessment of hedge effectiveness

- Under IFRS a qualitative approach is generally only allowed for the prospective assessment of hedge effectiveness, but only permitted in limited circumstances
- Under IFRS, assessment of hedge effectiveness on each reporting date is sufficient (i.e., does not have to be quarterly)

Measurement of effectiveness

- For a hedge of a forecasted transaction of non-financial assets/liabilities, IAS 39 permits adjustment of the basis of the hedged item for gains/losses on the hedging instrument rather than deferral of the gain/loss in equity – OCI.
- IAS 39 does not allow measurement of hedge effectiveness using a method that is solely based on variable cash flows – (i.e., method 1 under DIG G7)
- Purchased Options
    - No comparable accommodations
    - Change in time value of an option can create ineffectiveness in a cash flow hedge when the change in intrinsic value is designated as the hedging portion

Steps to Hedge Accounting

- Formulate policy
- Identify exposure
- Design strategy
- Document
- Execute
- Monitor

Documentation

- Formal documentation is required at the inception of the hedge and must include:
  - Identification of the hedging instrument and the hedged item or transaction
  - The nature of the risk being hedged
  - The risk management objective/strategy
  - How effectiveness will be assessed
  - How ineffectiveness will be measured

Liabilities

- The following types of instruments are classified as liabilities under IAS32:
  - Mandatorily redeemable financial instruments
  - Forward contracts to repurchase outstanding shares
  - Written put contracts on outstanding shares
  - Share-settled debt

Net Representation

- IAS 32 requires net presentation (offsetting) when, and only when:
  (1)Legally enforceable right to set off
  (2)Intention to settle net or simultaneously
  – Net Representation is not elective under IAS 32
  – There is no exception from the intent requirement for derivatives or repos subject to master netting agreements

Disclosure Requirements

- Governed by IFRS 7, which covers all financial instruments, not specifically derivatives
- Nature and extent of risks arising from financial instruments
  - Credit risk
  - Liquidity risk
  - Market risk

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*

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- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*

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About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*

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