Professional Certificate in International Accounting Standards for Financial Instruments

Derivatives under International Accounting Standards

Derivatives:
Derivatives are financial instruments whose value is derived from an underlying asset, index, interest rate, or other financial variable. They are used for hedging, speculation, and arbitrage purposes. Derivatives can be categorized as options, forwards, futures, and swaps.

Options:
Options are derivatives that give the holder the right, but not the obligation, to buy or sell an underlying asset at a specified price within a certain period. There are two types of options: call options (which give the holder the right to buy) and put options (which give the holder the right to sell).

Forwards:
Forwards are contracts between two parties to buy or sell an asset at a specified price on a future date. Unlike futures, forwards are not standardized and are traded over-the-counter (OTC).

Futures:
Futures are standardized contracts traded on exchanges that obligate the buyer to purchase an asset or the seller to sell an asset at a predetermined price on a specified future date. Futures are used for hedging and speculation.

Swaps:
Swaps are agreements between two parties to exchange cash flows or other financial instruments based on predetermined terms. Common types of swaps include interest rate swaps, currency swaps, and commodity swaps.

Interest Rate Swaps:
Interest rate swaps are derivative contracts where two parties agree to exchange interest rate payments. One party pays a fixed interest rate while the other pays a floating interest rate based on a reference rate such as LIBOR.

Currency Swaps:
Currency swaps are agreements between two parties to exchange principal and interest payments in different currencies. Currency swaps are used to hedge against exchange rate risk or to benefit from interest rate differentials.

Commodity Swaps:
Commodity swaps are contracts where two parties agree to exchange cash flows based on the price of a commodity. Commodity swaps are used by producers and consumers to hedge against price fluctuations.

Notional Amount:
The notional amount is the principal amount on which the cash flows of a derivative contract are calculated. The notional amount does not change hands and is used to determine the size of the cash flows.

Market Value:
The market value of a derivative is the current fair value of the contract, which may be positive (in-the-money), negative (out-of-the-money), or zero. Market value is used to determine the value of the derivative on the balance sheet.

Counterparty Risk:
Counterparty risk is the risk that the other party in a derivative contract will default on its obligations. Counterparty risk can be managed through collateral agreements and credit risk assessments.

Hedging:
Hedging is a risk management strategy used to offset potential losses from adverse price movements in the underlying asset. Derivatives are commonly used for hedging purposes to reduce risk exposure.

Speculation:
Speculation is the act of trading derivatives to profit from price movements in the underlying asset without the intention of taking delivery of the asset. Speculators take on risk in exchange for the potential for high returns.

Arbitrage:
Arbitrage is the practice of exploiting price differentials in the market by simultaneously buying and selling the same or similar assets to make a risk-free profit. Derivatives can be used in arbitrage strategies to capitalize on price discrepancies.

Fair Value Hedge:
A fair value hedge is a type of hedge where the derivative is used to offset changes in the fair value of a recognized asset or liability. The changes in the fair value of the derivative and the hedged item are recognized in the income statement.

Cash Flow Hedge:
A cash flow hedge is a type of hedge where the derivative is used to offset changes in cash flows associated with a recognized asset or liability. The effective portion of the hedge is recognized in other comprehensive income.

Effective Hedge:
An effective hedge is a hedge that significantly reduces the risk exposure of the hedged item. For hedge accounting to be applied, the hedge must be highly effective in offsetting the changes in fair value or cash flows.

Ineffective Hedge:
An ineffective hedge is a hedge that fails to offset the risk exposure of the hedged item. Ineffective portions of a hedge are recognized in the income statement and can impact financial performance.

Hedge Accounting:
Hedge accounting is a set of accounting rules that allows entities to designate certain derivatives as hedges and match the changes in their fair value or cash flows with the changes in the fair value or cash flows of the hedged item.

Derivative Liability:
A derivative liability is a financial obligation resulting from a derivative contract where the entity is obligated to make payments to the counterparty. Derivative liabilities are recorded at fair value on the balance sheet.

Derivative Asset:
A derivative asset is a financial asset resulting from a derivative contract where the entity has the right to receive payments from the counterparty. Derivative assets are recorded at fair value on the balance sheet.

Embedded Derivative:
An embedded derivative is a component of a hybrid financial instrument that contains a derivative feature. Embedded derivatives must be separated from the host contract and accounted for separately if certain criteria are met.

IFRS 9 Financial Instruments:
IFRS 9 is the International Financial Reporting Standard that sets out the accounting rules for financial instruments, including derivatives. IFRS 9 prescribes the recognition, measurement, and disclosure requirements for financial instruments.

Initial Recognition:
Initial recognition is the process of recording a derivative on the balance sheet when the contract is first entered into. Derivatives are initially recognized at fair value, and any transaction costs are capitalized.

Subsequent Measurement:
Subsequent measurement is the process of revaluing derivatives on the balance sheet at each reporting date. Derivatives are remeasured at fair value, with changes in fair value recognized in the income statement.

Reclassification:
Reclassification is the process of moving the fair value changes of a derivative from one category of the financial statements to another. Derivatives can be reclassified from fair value through profit or loss to other comprehensive income.

De-Recognition:
De-recognition is the process of removing a derivative from the balance sheet when the contract expires, is settled, or no longer meets the criteria for recognition. De-recognized derivatives are no longer reported on the balance sheet.

Effective Interest Rate Method:
The effective interest rate method is a method used to calculate the interest income or expense on financial instruments, including derivatives. The effective interest rate is the rate that discounts the future cash flows

to the net carrying amount of the financial asset or liability.

Impairment:
Impairment is the recognition of a decrease in the value of a financial asset, including derivatives. Derivatives are subject to impairment testing to determine if their fair value has declined below their carrying amount.

Contingent Consideration:
Contingent consideration is a payment that depends on the occurrence of a future event. Derivatives with contingent consideration features must be carefully evaluated to determine their fair value and appropriate accounting treatment.

Disclosures:
Disclosures are the requirements for providing comprehensive information about derivatives in the financial statements. Entities must disclose the nature and extent of their derivative activities, including risk exposures and accounting policies.

Interest Rate Risk:
Interest rate risk is the risk that changes in interest rates will affect the value of financial instruments, including derivatives. Entities must manage interest rate risk through effective hedging strategies and risk management practices.

Credit Risk:
Credit risk is the risk that the other party in a derivative contract will default on its obligations. Entities must assess and mitigate credit risk by monitoring counterparty creditworthiness and establishing collateral agreements.

Liquidity Risk:
Liquidity risk is the risk that an entity will not be able to meet its financial obligations due to a lack of market liquidity. Derivatives can be illiquid instruments, making it challenging to unwind positions in volatile markets.

Operational Risk:
Operational risk is the risk of loss resulting from inadequate or failed internal processes, systems, or human error. Entities must have robust operational controls and procedures in place to mitigate operational risk in derivative activities.

Model Risk:
Model risk is the risk that the valuation models used to price derivatives may be inaccurate or misapplied. Entities must validate their valuation models regularly and ensure they are appropriate for the complexity of the derivatives being valued.

Regulatory Risk:
Regulatory risk is the risk that changes in regulations or laws governing derivatives could impact an entity's ability to engage in derivative activities. Entities must stay informed about regulatory developments and

ensure compliance with applicable laws.

Market Risk:
Market risk is the risk that changes in market conditions, such as interest rates, exchange rates, or commodity prices, will affect the value of derivatives. Entities must actively manage market risk through hedging and risk mitigation strategies.

Counterparty Risk:
Counterparty risk is the risk that the other party in a derivative contract will default on its obligations. Entities must assess counterparty creditworthiness, establish collateral agreements, and monitor exposure to mitigate counterparty risk.

Model Validation:
Model validation is the process of ensuring that the valuation models used to price derivatives are accurate and appropriate for the complexity of the instruments being valued. Entities must validate their models regularly to mitigate model risk.

Derivative Pricing:
Derivative pricing is the process of determining the fair value of a derivative contract based on factors such as the underlying asset, interest rates, volatility, and time to maturity. Pricing models are used to calculate the value of derivatives.

Black-Scholes Model:
The Black-Scholes model is a mathematical formula used to price European-style options. The model takes into account factors such as the current price of the underlying asset, the option's strike price, time to expiration, risk-free rate, and volatility.

Monte Carlo Simulation:
Monte Carlo simulation is a computational technique used to model the possible outcomes of a derivative contract by simulating random variations in market factors such as prices, interest rates, and volatility. Monte Carlo simulation is used to calculate the value-at-risk of derivatives.

Value-at-Risk (VaR):
Value-at-Risk is a measure of the potential loss that could occur in a portfolio of derivatives over a specified time horizon at a given confidence level. VaR is used to assess and manage the risk of derivatives positions.

Delta Hedging:
Delta hedging is a strategy used to offset the risk of price movements in the underlying asset of a derivative contract. Traders adjust their positions in the underlying asset to match the delta of the derivative, reducing exposure to market fluctuations.

Gamma Hedging:
Gamma hedging is a strategy used to hedge against changes in the delta of a derivative contract. Traders adjust their positions in the underlying asset to account for changes in the sensitivity of the option's delta to price movements.

Vega Hedging:
Vega hedging is a strategy used to hedge against changes in the volatility of the underlying asset of a derivative contract. Traders adjust their positions in the underlying asset to offset the impact of changes in implied volatility on the derivative's value.

Theta Hedging:
Theta hedging is a strategy used to hedge against the time decay of an option contract. Traders adjust their positions in the underlying asset to offset the erosion of the option's value as it approaches expiration.

Risk Management:
Risk management is the process of identifying, assessing, and mitigating risks associated with derivative activities. Entities must have robust risk management policies and procedures in place to protect against potential losses.

Internal Controls:
Internal controls are policies and procedures implemented by entities to safeguard assets, ensure accurate financial reporting, and comply with regulations. Effective internal controls are essential for managing risks associated with derivative activities.

Compliance:
Compliance refers to the adherence to laws, regulations, and accounting standards governing derivative activities. Entities must ensure compliance with International Accounting Standards, regulatory requirements, and internal policies.

Audit:
Auditing is the process of examining an entity's financial statements and accounting records to ensure accuracy, compliance, and transparency. Auditors play a critical role in assessing the effectiveness of internal controls and risk management practices related to derivatives.

Financial Reporting:
Financial reporting is the process of preparing and presenting financial information to stakeholders, including investors, regulators, and creditors. Entities must provide transparent and accurate disclosures about their derivative activities in the financial statements.

IFRS Compliance:
IFRS compliance refers to the adherence to International Financial Reporting Standards in the preparation of financial statements. Entities must follow the accounting rules set out in IFRS, including the requirements for recognizing and measuring derivatives.

Disclosure Requirements:
Disclosure requirements are the rules for providing comprehensive information about derivative activities in the financial statements. Entities must disclose the nature and extent of their derivative holdings, risk exposures, accounting policies, and financial performance.

Financial Instruments:

Financial instruments are contracts that give rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Derivatives are a type of financial instrument used for risk management, speculation, and investment purposes.