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# Present Value & Fair Value

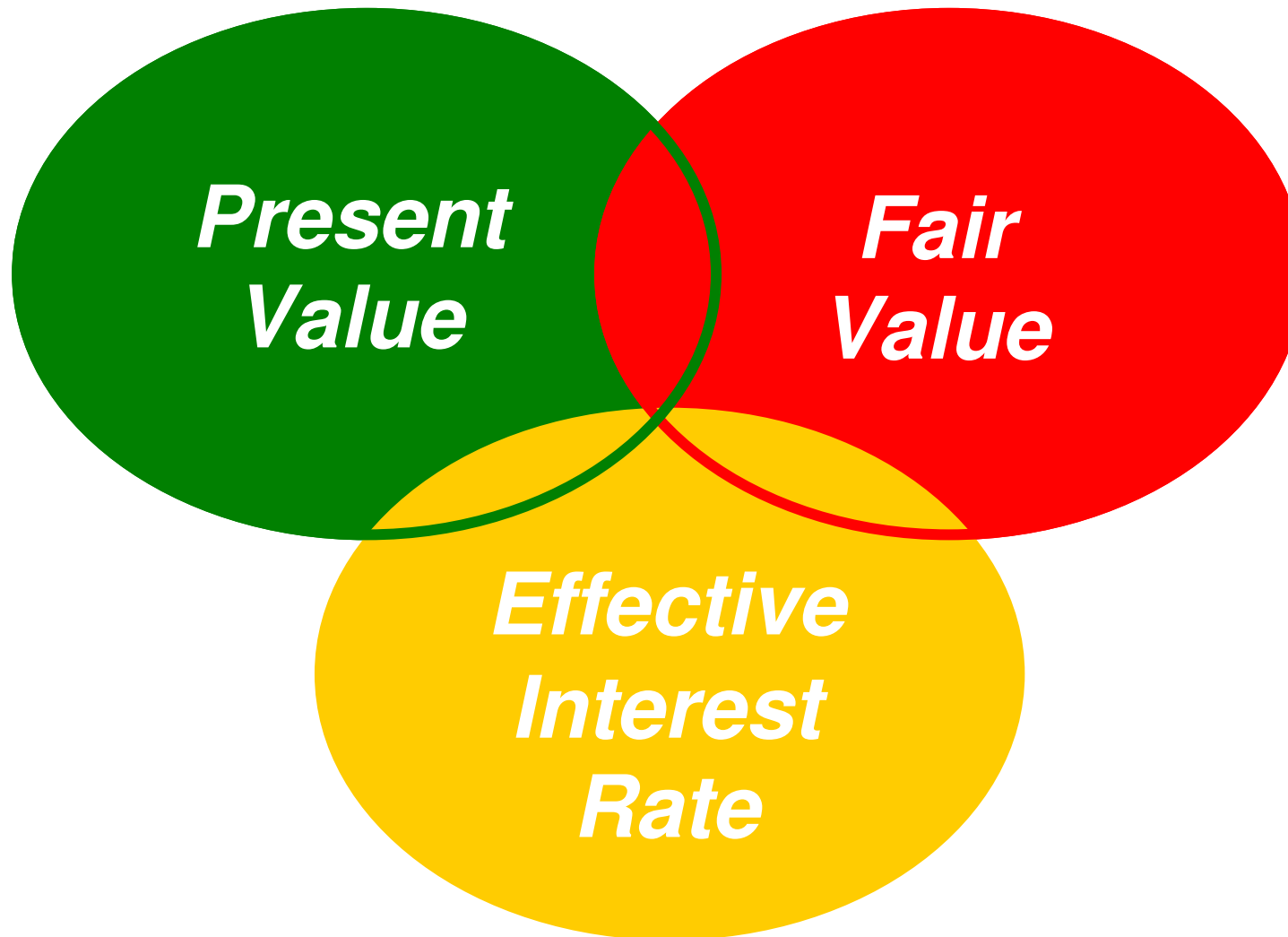
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Audit . Tax . Consulting . Corporate Finance .



# Three main concepts

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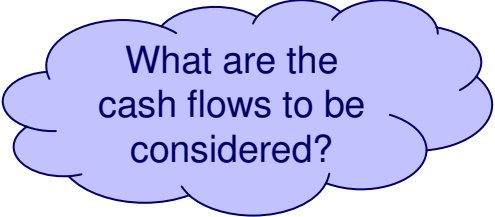
# Examples of application

Present Value	Fair Value	Effective Interest Rate
<ul style="list-style-type: none"><li>• IAS 39 – Financial Instruments, Recognition and Measurement</li><li>• IAS 32 – Financial Instruments Presentation</li><li>• IAS 37 – Provisions, Contingent liabilities and contingent assets</li><li>• IAS 36 – Impairment of Assets</li><li>• IFRS 5 – Non-current assets held for sale and discontinued operation</li><li>• IAS 19 – Employee Benefits</li><li>• IAS 26 – Accounting and Reporting by Retirement Benefit Plans</li><li>• IAS 17 – Leases (finance)</li></ul>	<ul style="list-style-type: none"><li>• IAS 39 – Financial Instruments, Recognition and Measurement</li><li>• IAS 32 – Financial Instruments Presentation</li><li>• IFRS 7 – Financial Instruments: Disclosures</li><li>• IFRS 3 – Business Combinations</li><li>• IAS 26 - Accounting and Reporting by Retirement Benefit Plans</li><li>• IAS 16 – Property, Plant and Equipment</li><li>• IAS 2 - Inventories</li></ul>	<ul style="list-style-type: none"><li>• IAS 39 – Financial Instruments, Recognition and Measurement</li><li>• IAS 32 – Financial Instruments Presentation</li><li>• IAS 18 – Revenue</li></ul>

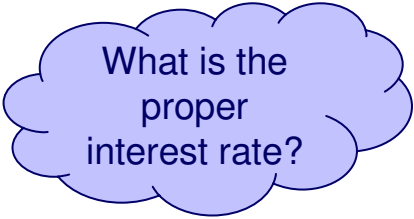
# Present value

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- Estimated future cash inflow or outflow,
- discounted at an interest rate for the related period



What are the cash flows to be considered?



What is the proper interest rate?

# Present value - examples

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(IAS 32.23) – “(...)A contract that contains an obligation for an entity to purchase its own equity instruments (...) gives rise to a financial liability for the present value of the redemption amount(...)”

(IAS 36.6) – “Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.”

(IAS 37.45) – “Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.”

(IAS 12.53) – “Deferred tax assets and liabilities shall **not** be discounted.”

# Fair value

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Transaction price in an arm's length transaction  
motivated by normal business considerations

- Best evidence of fair value is quoted prices in an active market.
- If the market is not active, use a valuation technique.
- No “Day 1 gains and losses”



Significant judgement!

# Fair value - examples

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(IAS 17.20) “At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments (...)”

(IAS 39.43) – “When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value (...)”

(IFRS 2.39) – “At the date of settlement, the entity shall remeasure the liability to its fair value (...)”

# Effective interest rate

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- Exactly discounts estimated future cash payments or receipts,
- through the expected life of the financial instrument or, where appropriate,
- a shorter period to the net carrying amount of the asset or liability

# Effective interest rate - example

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(IAS 39.46) – “After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, (...), except for the following financial assets:

(a) loans and receivables (...), which shall be measured at amortised cost using the effective interest method;

(b) held-to-maturity investments (...), which shall be measured at amortised cost using the effective interest method; (...)”

# Discount rates

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## Risk Free Rate

Rate that a creditor will accept to receive a risk-free cash flow now rather than at the due date

## Risk Adjusted Rate

Based on general corporate bond rate reflects general corporate credit risk

Based on an entity-specific corporate bond rate or weighted average cost of capital reflects risk factors specific to an entity

# Discount rates

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## Explicit Rate

Borrowing of R\$ 1,000 for one year, paying 15% p.a.

## Implicit Rate

Sale of goods for R\$ 1,150 to be paid in one year  
If paid in cash, the same goods cost R\$ 1,000

## “Off-Market” Rate

Loan obtained from related party at below market interest rates (e.g. Borrower is A-rated and should pay 6% but receives a loan for 3%)

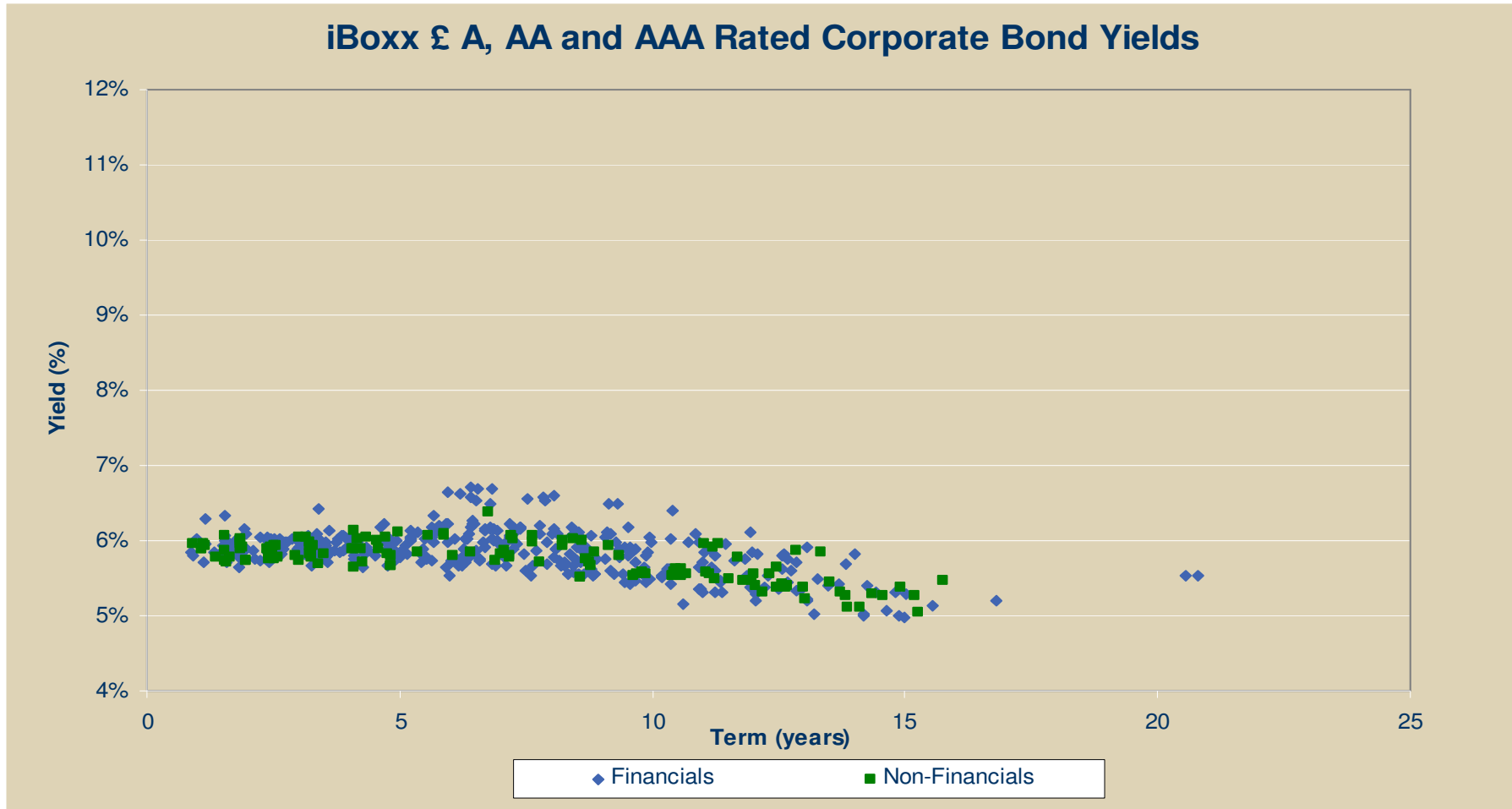
# Discount rates

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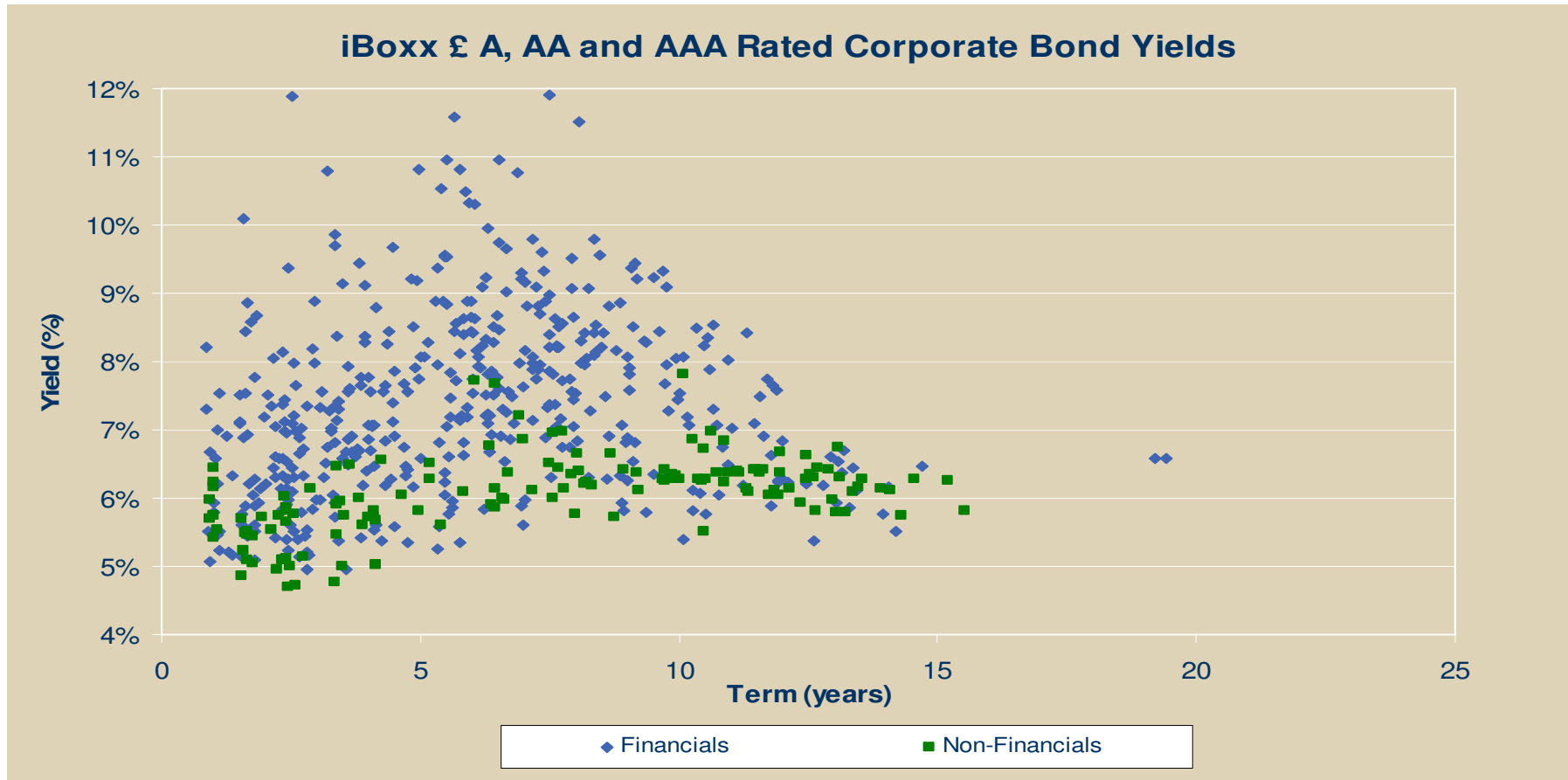
## •Why does it matter?

- ✓ Pension liabilities based on “high quality corporate bond rates”
- ✓ “Off market” loans may have to be adjusted to fair value
- ✓ Account receivables/payables may have to be discounted
- ✓ Provisions for contingencies may have to be discounted
- ✓ .....

# iBoxx corporate bond yields at 31 March 2007



# iBoxx corporate bond yields at 31 March 2008



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