PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
10-18 Union Street
London SE1 1SZ
Telephone +44 (0) 20 7583 5000
Facsimile +44 (0) 20 7822 4652
www.pwc.com/uk

Tricia O'Malley
IFRIC Co-ordinator
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

28 June 2007

Dear Ms O'Malley

IFRIC Tentative Agenda Decision: IAS 39 Financial Instruments: Recognition and Measurement—Hedging future cashflows with purchased options

We are responding to your invitation to comment on the above Tentative Agenda Decision, published in the May 2007 edition of IFRIC Update, on behalf of PricewaterhouseCoopers. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on the agenda decision. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We note that the IFRIC was asked how effectiveness should be assessed when an option, in its entirety, is designated as a hedging instrument to hedge variability in future cash flows in a cash flow hedge. In particular, a methodology was considered that involved a comparison of all changes in the fair value of the purchased option with changes in the fair value of a hypothetical written option that has the same maturity date and notional amount as the hedged item. The IFRIC is proposing not to take the issue onto its agenda because this approach is prohibited by IAS 39 for the following reasons:

1. The suggested hypothetical derivative approach would effectively result in considering the time value component of an option (that does not exist in the hedged item) in determining changes in the fair value of the hedged item for assessing and measuring hedge effectiveness.
2. Derivatives cannot be designated as hedged items (except in limited fair value hedging situations)

In contrast, we believe that the proposed approach is permitted by IAS 39 for the following reasons:

1. IAS 39 does not specify a single method for assessing hedge effectiveness. Rather the method an entity adopts for assessing hedge effectiveness depends on its risk management strategy (IAS 39.AG 101). IG F.5.5 (method B) explicitly permits the use of a hypothetical derivative method of assessing hedge effectiveness.

PricewaterhouseCoopers LLP is a limited liability partnership registered in England with registered number OC303525. The registered office of PricewaterhouseCoopers LLP is 1 Embankment Place, London WC2N 6RH. PricewaterhouseCoopers LLP is authorised and regulated by the Financial Services Authority for designated investment business.

2. IAS 39.86(b) defines a cash flow hedge as a hedge of the exposure to variability in cash flows attributable to a particular risk, while IAS 39.96(a) requires that the cumulative change in fair value of the expected future cash flows are considered. In this case, the hedged risk is a one-sided risk: that is the risk that the exchange rate will exceed a specified rate. The change in fair value of the hedged one-sided cash flows should include the possibility that, even if the exchange rate is below the specified level today, this may not continue to be the case. This element is captured by using a probability weighted approach reflecting the volatility of exchange rates, which is equivalent to an option pricing model. Consequently, the perfect hypothetical derivative to hedge such a risk would be a purchased option. Ineffectiveness would arise to the extent there are differences between the actual derivative used and the hypothetical derivative that best models the change in fair value of the forecast cash flows for the hedged one-sided risk.

3. This approach does not imply that the hedged item is a written option. Rather it simply models the changes in expected cash flows that constitute the hedged risk.

We further note:

- The wording in FAS 133.30 which led to interpretation DIG G20 permitting the hypothetical derivative approach under US GAAP is virtually identical to the wording in IAS 39.96. Therefore we do not believe that a GAAP difference should arise in this area.
- The IASB is undertaking a project to consider which what portions can be designated as hedged items at inception of the hedge. We believe that a one-sided risk is a portion of a forecast transaction and therefore this topic should be considered in that broader context.
- In the past, IFRIC has indicated that it would not comment on implementation issues relating to measuring hedge effectiveness and this topic relates to measurement of effectiveness.

For the reasons discussed above, we do not believe that IAS 39 prohibits the proposed approach and therefore do not agree that this is an appropriate basis for the IFRIC to reject the request. Unless there are other grounds for rejection, this matter is most appropriately addressed by an interpretation. In this regard, we note that the proposed approach is relatively widely used and its prohibition would have a material effect in practice.

oooOOOOooo

If you have any questions in relation to this letter please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7802 4555), or Pauline Wallace (+44 20 7804 1283).

Yours sincerely,

PricewaterhouseCoopers LLP