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Sent via post and email to: ifric@iasb.org

Re: IFRIC Tentative Agenda Decision: IAS 39 *Financial Instruments: Recognition and Measurement* – Hedging future cash flows with purchased options

Dear IFRIC Members

Credit Suisse is pleased to respond to IFRIC's publication in the May 2007 IFRIC Update of the tentative decision not to take onto its agenda a request for an interpretation on how to assess effectiveness for hedges of future cash flows with purchased options.

In summary, we disagree with IFRIC's view that this question does not require a full interpretation. We understand the basis for IFRIC's rejection is its view that IAS 39 and existing Implementation Guidance provide sufficient guidance on two questions that should be considered in addressing the treatment of option time value in cash flow hedges with purchased options:

- a) whether a hedged item used for assessing and measuring hedge effectiveness should be the same as that designated at inception of the hedge; and;
- b) what items are eligible for designation as hedged items at inception of the hedge.

We disagree that these two questions are fundamental to the issue. We believe the fundamental question, with respect to assessing effectiveness for hedges of future

cash flows with purchased options, that IFRIC should consider is the same question that US GAAP DIG Issue G20 addresses:

When designating a purchased option as hedging the exposure to variability in expected future cash flows attributable to a particular rate or price beyond a specified level – with the entity documenting that assessment will be based on total changes in the options cash flows (i.e., assessment will include the hedging’s instrument entire change in fair value) – can an entity focus on the hedging instrument’s terminal value (that is, expected future pay-off amount at its maturity date) in determining whether the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge? (emphasis added)

Because this question is not addressed in the IFRIC deliberations, perhaps because the submission may not have raised it, we believe that it remains unclear if a DIG G20 approach is allowed under IFRS.

In our opinion, IAS 39 does not provide guidance on this question. IAS 39. 88(b)/AG 105 considers a cash flow hedge as highly effective if the hedge is highly effective in achieving offsetting changes in cash flows attributable to hedged risk during the period for which the hedge is designated. IAS 39 does not give further guidance as to whether the offset in cash flows can be based on terminal cash flows or must be based on cash flows discounted back to the balance sheet date.

The argument for discounting back to the balance sheet date, is that the balance sheet date is the assessment date. We believe that an interpretation that focuses on the option’s terminal value can also be supported. Allowing an entity to focus on terminal value of the purchased option (that is, expected future pay-off amount at its maturity date) would be consistent with the treatment currently allowed in IAS 39 for hedges with forward contracts. IAS 39.74(b) allows an entity to either include the interest element of the locked in forward price (“forward method”) or to exclude the interest element (“spot method”) in the designation of forward contracts as hedges. We note that an effectiveness assessment based on the forward method implicitly focuses on the terminal value of the forward contract. We see no reason for a different treatment between the discount /premium points of a forward contract and the time value of an option contract as both are the cost of entering into a hedge. Focusing on the terminal cash flow of the hedging instrument can result in effectively applying the matching principle to these hedging costs. Applying the forward method to a highly effective cash flow hedge with a forward contract accomplishes that the hedging cost (discount/premium) is deferred in shareholder’s equity and released when the hedged cash flow affects earnings. Similarly, a focus on offset of terminal cash flows in cash flow hedges with purchased options results in the hedging cost (changes in time value) being deferred in shareholders’ equity and released when the hedged cash flow affects earnings.

Secondly, we feel the language in IAS 39, paragraph 96 supports an interpretation that in hedging future cash flows with purchased options,, time value changes of the option should not result in ineffectiveness. Paragraph 96 states:

“More specifically, a cash flow hedge is accounted for as follows:

- (a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):*
 - (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and*
 - (ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;” (emphasis added)*

This paragraph requires a comparison in the cumulative gain or loss on the derivative with the “cumulative change in fair value of the expected future cash flows” on the hedged transaction. IAS 39 does not give further guidance how to determine the change in expected future cash flows on the hedged item. We believe that the “cumulative change in fair value of the expected future cash flows on the hedged item from inception of the hedge” with a hedge instrument which provides only one-sided offset against the hedged risk is the sum of the probability weighted possible outcomes within the hedge strategy. Each price outcome at the time of the forecasted transaction has a probability at any time during the option’s life. If the hedged cash flow for each possible price outcome is present valued and multiplied by the probability of that outcome, the total will be the expected value of the future hedged cash flows. Because binomial tree option pricing models follow the same approach to estimating the fair value of an option, it follows that the all-in gains and losses on an option (both time value and intrinsic value) will be equal in magnitude to changes in the expected value of hedged cash flows. Accordingly, per paragraph 96, all changes in fair value of the option would be recorded in shareholders’ equity and none in earnings.

As mentioned above, we do not believe that the two questions considered by IFRIC are relevant to the question on how to treat time value of net purchased options in cash flow hedges. The reasons are the following:

- IFRIC have considered this issue in the context of viewing the hedged item as a written option. In an approach based on DIG Issue G20, the hedged item would not be defined as a written option. The hedged item is the variability in future cash flows, with the entity documenting that it will assess effectiveness based on the option’s entire change in value and focusing on the hedging instrument’s terminal value. Accordingly, we do not believe question (b) in the IFRIC rejection wording is relevant to the question of how to treat time value in cash flow hedges with net purchased options.

- The hedged item and the method used for assessing and measuring hedge effectiveness under a DIG Issue G20 approach do not change during the term of the hedge. The *hedged item* remains the variability in future cash flows. The *method* to assess and measure ineffectiveness remains the hypothetical derivative method. If the hedged forecasted transaction does not change¹, the terms of the hypothetical derivative (a *purchased option*) do not change during the term of the hedge. Accordingly, we do not believe question (a) in the IFRIC rejection wording is relevant to the issue.

Finally, we note that under US GAAP the focus on terminal value for certain purchased options designated as cash flow hedges has been allowed – and widely applied - since 2001. Elimination of this difference in interpretation of what cash flow offset should be considered in assessing the effectiveness of certain cash flow hedges with purchased options would be consistent with the IASB's and FASB's commitment to convergence of accounting standards.

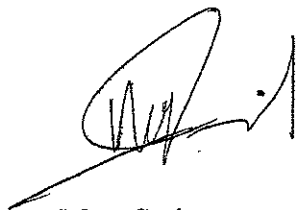
We recommend that IFRIC take this issue on its agenda and deliberate the same questions that have been addressed in DIG Issue G20. Should IFRIC not decide to take the issue on its agenda, we recommend IFRIC redraft the rejection wording to address the issues (focus on terminal value) that are relevant to the issue of how to treat purchased option time value in cash flow hedges.

If you have any questions concerning our comments, please do not hesitate to contact Todd Runyan on +41 44 334 8063 or Marc Smit on + 61 39 280 1689.

Sincerely,



Rudolf Bless
Managing Director, Chief Accounting Officer



Marc Smit
Director, Accounting Policy and Assurance

¹ Note that this is no different to the hypothetical derivative method described IG F5.5. If the timing of the hedged forecasted interest payments would change, the hypothetical derivative in IG F5.5 would change as well.