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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **July 2007, London**

Project: **Comments on a tentative agenda decision – Hedging future cash flows with purchased options (Agenda Paper 7C(i))**

SUMMARY OF THE ISSUE

1. The issue relates to a situation in which a purchased option in its entirety is designated as a hedging instrument to hedge variability in future cash flows in a cash flow hedge.

2. The submissions suggested an approach to assessing and measuring hedge effectiveness – that is, an entity can compare changes in the fair value of the purchased option (the hedging instrument) with changes in the fair value of a hypothetical written option that has the same maturity and notional amount as the hedged item (the 'Submission Approach'). The submissions asked whether the Submission Approach is allowed under IAS 39.

SUMMARY OF ARGUMENTS RAISED IN THE COMMENT LETTERS

3. The IFRIC has received eight comment letters on this tentative agenda decision (see Agenda paper 7C Attachments 1-8).

4. Most of the arguments raised in the comment letters were discussed by the IFRIC in May 2007. The purposes of this paper are to:

- give a summary of arguments raised in the comment letters against the tentative agenda decision; and
- remind the IFRIC the concerns over those arguments.

5. Key arguments raised in the comment letters include:

Arguments raised in the comment letters	**Concerns over the arguments**
1) F.5.5 of the Guidance on Implementing IAS 39 (Method B) allows the use of a hypothetical derivative method to assess hedge effectiveness.	The IFRIC discussed this argument in May 2007. The IFRIC noted that the Submission Approach is different from the ‘hypothetical derivative method’ set out in IG F.5.5 for the following reasons: • IG F.5.5 uses the *same* hedged item for (i) hedge designation at the inception of the hedge and for (ii) assessing and measuring hedge effectiveness over the life of the hedging relationship. • The use of a ‘hypothetical derivative method’ in IG F.5.5 is *solely* to demonstrate how to use forward interest rates to estimate what the market interest rate will be when the forecast transaction occurs (in order to determine changes in the fair value of the hedged item). • The application of IG F.5.5 does not result in terms/features that *do not exist* in the hedged items being considered in assessing and measuring hedge effectiveness. • However, the Submission Approach essentially results in the time value feature of an option that *does not exist in the hedged item* being considered in determining the changes in fair value of the hedged item for assessing and measuring hedge effectiveness.

Arguments raised in the comment letters	**Concerns over the arguments**
2) The hedged exposure is a one-sided risk (e.g. a risk that the exchange rate will exceed a specified rate). Some respondents believe that, in determining changes in the fair value of the *hedged item*, an entity is allowed to use a probability weighted approach (based on the volatility in exchanges rates) to reflect the uncertainty that the option will be in-the-money at the maturity date. They stated that such an approach is equivalent to an option pricing model.	The IFRIC noted that the hedged exposure was a one-sided exposure when it discussed the issue in May 2007. When an entity designates a one-sided risk as a hedged risk for hedge accounting purposes, it should *only* consider cash flows and changes in fair value of the hedged item associated with the one-sided risk over the life of the hedge (see F.1.10 of the Guidance on Implementing IAS 39). For example, when a one-sided risk is a risk that the exchange rate will exceed a specific rate, the entity should *only* take into account the cash flows arising when the future exchange rate exceeds the specific rate. It should *not* consider cash flows or changes in fair value arising from the future exchange rate falling below the specified rate. *This is because the hedged item includes no optionality*. For a hedge of a forecast transaction to qualify for hedge accounting, the forecast transaction must be highly probable. Therefore, the one-sided exposure of a forecast transaction must also be highly probable. Hence, it is difficult to accept an argument than an eligible portion of a forecast transaction under IAS 39 includes the optionality feature. However, the determination of the fair value of *an option* takes into account probability (that is, whether or not the option will be in-the-money based on current expectations). Such a consideration reflects the option's optionality feature. In summary, a one-sided hedged risk as a portion does not include the optionality feature. However, the determination of the fair value of an option does take the optionality feature into consideration. That's why paragraph 74 of IAS 39 allows an entity to hedge only the intrinsic value of an option as a hedging instrument.

Arguments raised in the comment letters	**Concerns over the arguments**
3) DIG G20 under US GAAP allows an entity to use hypothetical derivative approach for testing effectiveness, when a purchased option is designated as a hedging instrument.	It is important to bear in mind that the IFRIC was asked whether the Submission Approach is allowed under IFRSs (not whether the issue raised in DIG G20 is allowed under IFRSs). In addition, when the IFRIC discussed this issue in May 2007, the IFRIC noted that there are a number of *important differences between IAS 39 and US GAAP* in respect of hedge accounting requirements (both in terms of eligible hedged items and portions as well as the requirements regarding effectiveness). For example, US GAAP allows the 'short-cut' method while IAS 39 does not. Hence, the IFRIC focused on existing IFRS requirements when it discussed the issue. Moreover, it is important to note that DIG G20 existed when the former IAS 39 Implementation Guidance Committee (the IGC) developed a series of questions and answers relating to the application of IAS 39. If the IGC believed that the approach in DIG G20 was allowed under IFRSs, it should have included that approach in the Implementation Guidance. Similarly, if the Board agreed with the approach set out in DIG G20, it should have included that approach when it revised IAS 39 in 2003. Both the Board and the former IGC did not include the approach set out in DIG 20 in IAS 39 and the Implementation Guidance. These facts might indicate that both the Board and the former IGC did not believe that the approach set out in DIG G20 was allowed under IAS 39.

Arguments raised in the comment letters	Concerns over the arguments
4) The IFRIC pointed out in its tentative agenda decision that IAS 39 does not allow any derivatives to be designated as hedged items, subject to one exception (that is a purchased option in a fair value hedge). Some respondents noted that IAS 39 allows a prepayment risk to be designated as a hedged risk (see paragraph 79 of IAS 39). They believed that a prepayment option can be considered as a written option.	[Paragraphs omitted from observer noted.]

STAFF RECOMMENDATION

6. [Paragraph omitted from observer note.]

7. [Paragraph omitted from observer note.]

8. [Paragraph omitted from observer note.]

9. [Paragraph omitted from observer note.]

QUESTION FOR THE IFRIC

10. Does the IFRIC agree with the staff recommendation? If not, how does the IFRIC wish to proceed with the issue?