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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **May 2007, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement* – Hedging future cash flows with purchased options (Agenda Paper 11(ii))**

BACKGROUND INFORMATION

1. In 2006, the IFRIC received submissions regarding a situation in which a purchased option in its entirety was designated as a hedging instrument to hedge variability in future cash flows in a cash flow hedge.

2. For example,

   - Entity A has exposure to cash flow variability arising from a highly probable future sale denominated in foreign currency.
   - It purchases a European-style[1] option to hedge against a one-sided risk, that is the risk that the foreign exchange rate will have depreciated by the time the forecast sale occurs (the 'downside foreign currency' risk).

[1] A European option can only be exercised at the expiration date.

- The purchased option gives Entity A the right to convert a fixed amount of foreign currency at a pre-determined rate (the 'strike price') to its functional currency.

SUMMARY OF THE ISSUE

3. A purchased option in its entirety is designated as a hedging instrument at inception of the hedge. Consequently, in assessing and measuring hedge effectiveness, all changes in the fair value of the purchased option are required to be considered.

4. Changes in the fair value of a purchased option are attributable to (i) changes in its intrinsic value component and (ii) changes in its time value component. Changes in the time value component of a purchased option arise due to the optionality feature of the option – that is the holder's right to choose whether or not to exercise the option.

5. However, the hedged item (i.e. variability in future cash flows attributable to decrease in the foreign exchange rate) does not include any optionality feature.

6. Consequently, ineffectiveness may arise when measuring hedge effectiveness. Certain changes in the fair value of the purchased option (particularly, changes in the time value component of the purchased option) may be required to be recognised in profit or loss immediately.

7. To reduce hedge ineffectiveness, the submissions suggest an approach. The submissions suggest that, in assessing and measuring hedge effectiveness, an entity can compare changes in the entire 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 forecast transaction (the Submission Approach).

8. Under the Submission Approach, a hypothetical written option is constructed.

9. The Submission Approach requires the entity to consider changes in the time value component of an option in determining changes in the fair value of the

hedged item for assessing and measuring hedge effectiveness. Such a time value component is hypothetical and does not exist in the hedged item.

10. Under the Submission Approach, ineffectiveness will be minimized or eliminated (when the terms of the purchased option and the hypothetical written option perfectly match).

11. The submissions ask whether the Submission Approach is allowed under IAS 39.

12. The submissions argue that such an approach is allowable under IAS 39 for the following reasons:

    - F.5.5 of the Guidance on Implementing IAS 39 allows an entity to use the hypothetical derivative approach in assessing and measuring hedge effectiveness (although the circumstances illustrated in IG F.5.5 and the submissions are different);

    - DIG G20 under US GAAP specifically allows an entity to use a 'theoretical-type' option for testing effectiveness when a purchased option is designated as a hedging instrument; and

    - Ineffectiveness can be reduced or eliminated if the approach suggested by the submissions was allowed (i.e. changes in the time value component of the purchased option can be deferred in equity until the hedged item affects profit or loss).

13. The issue, therefore, is whether an entity is allowed to consider the time value of a hypothetical option (which does not exist in the hedged item) in determining changes in the fair value of the hedged item for assessing and measuring hedge effectiveness.

14. The IFRIC has not yet discussed the issue. At the April 2006 Agenda Committee meeting, it was suggested that the IFRIC should not address the above issue until further progress had been made regarding eligible 'portions' for hedge accounting purposes.

STAFF ANALYSIS

15. Before discussing further how the issue should be addressed, the section below considers the arguments raised by the submissions (see paragraph 12 of this paper).

A) F5.5 Guidance on Implementing IAS 39

16. Though the submissions 'label' the approach as a hypothetical derivative approach, it is crucial to differentiate the Submission Approach from the hypothetical derivative method set out in IG F.5.5 of the Guidance on Implementing IAS 39.

17. IG F.5.5 allows an entity to use the hypothetical derivative approach in assessing and measuring hedge effectiveness in a situation in which an interest rate swap is used to hedge variability in future interest payments of a forecast debt investment or a forecast debt issuance.

18. IG F.5.5 uses the *same* hedged item for hedge designation at inception of the hedge and for assessing and measuring hedge effectiveness over the life of the hedging relationship. The hedged item is the variability in future interest receipts or interest payments of the forecast debt investment or the forecast debt issuance.

19. The use of the hypothetical derivative method in IG F.5.5 is solely for estimating the market interest rate for the forecast transaction at the time when the forecast transaction occurs in order to determine changes in the fair value of the hedged item. In other words, the sole purpose of the hypothetical derivative method in IG F.5.5 is to find a reference point to estimate the market interest rate at the time when the forecast transaction takes places.

20. The use of the hypothetical derivative example in IG F.5.5 does not result in terms/features which do not exist in the hedged items being considered in assessing and measuring hedge effectiveness. However, the approach suggested by the submissions takes into account the optionality (or 'time value') feature (which does not exist in the hedged item).

B) DIG G20 under US GAAP

21. Some note that DIG G20 under US GAAP explicitly allows an entity to use a 'theoretical-type' option for testing effectiveness when a purchased option is designated as a hedging instrument. They argue that, if IAS 39 did not permit an entity to apply the approach proposed by the submissions (see paragraph 3 of this paper) in assessing and measuring hedge effectiveness, divergence with US GAAP would be created.

22. It is worth noting that there are differences between IAS 39 and US GAAP in respect of hedge accounting requirements, particularly as to what 'portions' can be designated as hedged items and the 'short-cut' method allowed under Statement No.133 *Accounting for Derivative Instruments and Hedging Activities*. Consequently, US GAAP is already different from IAS 39 in this area.

23. Moreover, some believe that the approach suggested by the submissions is similar to the 'shortcut' method. Under the 'short-cut' method, when the terms of the hedging instrument and the forecast transaction (e.g. the maturity date, notional amount etc.) perfectly match, no ineffectiveness would arise.

24. The Board did consider whether the 'short-cut' method should be allowed in IAS 39 when it developed IAS 39. The Board noted that, if the 'short-cut' method were permitted, an exception would have to be made to the principle in IAS 39 that ineffectiveness in a hedging relationship is measured and recognised in profit or loss. The Board finally agreed that no exception to this principle should be made, and therefore concluded that IAS 39 should not permit the 'short-cut' method (see paragraphs BC132 – 135 of IAS 39).

C) The purpose of hedge accounting is *not* to minimize or eliminate hedge ineffectiveness

25. Obviously, ineffectiveness can be minimized or eliminated if the Submission Approach was allowed.

26. However, the purpose of hedge accounting in IAS 39 is not to minimize or eliminate hedge ineffectiveness. If the purpose of hedge accounting was to minimize hedge ineffectiveness, portions that mirror the hedging instrument

should always be allowed to be designated as hedged items. However, that is clearly not the objective of hedge accounting in IAS 39.

27. Hedge accounting in IAS 39 focuses on the degree of offset between changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk (identified at the inception of the hedge) and changes in the fair value or cash flows of the hedging instrument (identified at the inception of the hedge).

28. Moreover, there are other approaches to minimizing hedge ineffectiveness. IAS 39 paragraph 74 specifically allows an entity to designate the intrinsic value of an option as a hedging instrument. If an entity at inception of the hedge designates only the intrinsic value component of a purchased option as a hedging instrument, perfect effectiveness could also be achieved (provided that the hedging instrument and the forecast transaction have the same maturity dates and notional amounts).

HOW TO ADDRESS THE ISSUE?

29. To address the issue, the following two related questions have to be considered:

- Question 1 - Whether the hedged item used for assessing and measuring hedge effectiveness should be the same as that designated at inception of the hedge; and
- Question 2 - What items are eligible for designation as hedged items at inception of the hedge?

30. There are at least three possible approaches to these issues, which include:

- **Approach 1** – A hedged item can be anything for both hedge designation and hedge effectiveness purposes. Under this approach, hedge effectiveness tests would be meaningless;
- **Approach 2** – There are restrictions as to what can be designated as hedged item at inception of the hedge. In addition, the hedged item used for assessing and measuring hedge effectiveness should be the same as that designated at inception of the hedge; and
- **Approach 3** – There are restrictions as to what can be designated as a hedged item. However, the hedged item used for assessing and measuring hedge

effectiveness can be something different from that designated at inception of the hedge. Under this approach, the restrictions as to what can be designated as a hedged item would also be meaningless.

Question 1 - Should the hedged item for assessing and measuring hedge effectiveness be the same as that designated at inception of the hedge?

31. This section addresses whether something that is different from the designated hedged item at inception of the hedging relationship can be used for assessing and measuring hedge effectiveness.

32. Numerous paragraphs in IAS 39 require that the hedged item used for assessing and measuring hedge effectiveness should be the same as the hedged item designated and documented at inception of the hedge, as follows.

    - IAS 39 paragraph 88(a) states: 'At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.'
    - IAS 39 paragraph 88(b) states: 'The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.'

33. There are restrictions as to what can be designated as a hedged item at inception of a hedge. If the hedged item used for assessing and measuring hedge effectiveness can be anything different than the hedged item designated at inception of the hedge, the restrictions regarding the designation of hedged items would become meaningless.

Question 2 - What can be designated as hedged items at inception of the hedge?

Requirements under IAS 39

Can a derivative ever be designated as a hedged item at inception of the hedge?

34. As mentioned earlier, the approach suggested by the submissions requires a hypothetical written option to be constructed and to be considered as a hedged item for assessing and measuring hedge effectiveness.

35. IG F.2.1 of IAS 39 notes that IAS 39 requires all derivatives to be deemed as held for trading subject to an exception – that is a purchased option. A purchased option (e.g. a purchased option embedded in a callable liability) can be designated as a hedged item.

36. Clearly, IAS 39 does not allow a written option (whether it is actual or hypothetical) to be designated as a hedged item.

Can an item that includes cash flows that do not exist be designated as a hedged item at inception of the hedge?

37. As mentioned above, the forecast transaction does not have the optionality feature: if the designated hedged item includes the optionality value then an entity would effectively consider cash flows that do not exist in the hedged item in assessing and measuring hedge effectiveness.

Interaction with the Board's project on 'portions'

38. When the IFRIC discussed the submissions regarding eligible 'portions', it concluded that IAS 39 was not clear and decided to ask the Board to clarify.

39. At its meeting in December 2006, the Board decided to propose an amendment to IAS 39 to clarify what portions can be designated as hedged items at inception of the hedge.

40. To determine what can be designated as hedged items, the Board at that meeting agreed that it is crucial to identify what can be designated as hedged risks first.

The eligible hedged risks would then form a basis for the identification of eligible hedged items.

41. The Board tentatively decided the proposed amendment would specify that the following risks are eligible for designation as hedged risks (either in full or as a 'portion')[2]:

    - market interest rate risk;
    - foreign currency risk;
    - credit risk;
    - prepayment risk; and
    - risks associated with the cash flows of a financial instrument that are contractually specified and are independent of the other cash flows of the same financial instrument.

42. Even before the Board's December discussion on 'portions', it is clear that IAS 39 allows a one-sided risk to be designated as a hedged risk when the hedged item is a financial instrument[3].

43. Even if IAS 39 allows an entity to designate a one-sided risk as a hedged risk, it does not mean that changes in time value component of an option can be taken into account for the purposes of assessing and measuring hedge effectiveness.

[2] The Board stated the intention of the amendment is not to change the commonly adopted practice regarding what portions can be designated as hedged items.
[3] See F.1.10 of the Guidance on Implementing IAS 39.

STAFF RECOMMENDATION

44. As mentioned above, it is clear in IAS 39 that the hedged item used for assessing and measuring hedge effectiveness should be the same as that designated at inception of the hedge.

45. As explained in paragraphs 35-38 of this paper, IAS 39 does not allow the approach suggested by the submissions.

46. Furthermore, the Board already agreed to propose an amendment to IAS 39 to clarify what portions can be designated as hedged items.

47. For the above reasons, the staff recommends that the IFRIC should *not* take the issue onto its agenda.

48. Wording for the proposed tentative agenda decision is set out below: [Paragraph omitted from observer note].

QUESTIONS TO THE IFRIC

49. Does the IFRIC agree that the issue should not be taken onto the agenda? If not, why not?