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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 May 2008, London**

Project: ***IAS 39 Financial Instruments: Recognition and Measurement,*** **Exposures Qualifying for Hedge Accounting (ED)**

Subject: **Designation of a purchased option (Agenda paper 10B)**

INTRODUCTION

1. This paper addresses the designation of a purchased option in its entirety as the hedging instrument of a hedged item that contains no optionality, in such a way that no ineffectiveness arises (paragraph AG99E of the ED). This paper sets out:
    a) the background
    b) the staff's recommendation
    c) an analysis of the issue, including consideration of comments by respondents to the ED.

BACKGROUND

2. In 2006 the IFRIC received submissions regarding the designation of a purchased option in its entirety as a hedging instrument to hedge the variability in future cash flows (a cash flow hedge). The submissions asked for guidance regarding the assessment of effectiveness, and suggested that the effectiveness of such a designation might be assessed by comparing changes in the entire fair value of the purchased option with

changes in fair value of a hypothetical derivative[1] (a written option) that has the same maturity date and notional amount as the forecast transaction. Such an approach would minimise or eliminate any ineffectiveness in the hedging relationship.

3. The IFRIC decided that such an approach was not consistent with the requirements of IAS 39 and issued the following draft rejection in IFRIC Update in May 2007.

> 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. All changes in the fair value of the option (including changes in the time value component) are considered in assessing and measuring hedge effectiveness.
> The requests suggested the following approach to assessing and measuring hedge effectiveness. An entity could compare 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 requests noted that such an approach would minimise or eliminate hedge ineffectiveness when the terms of the purchased option and the hypothetical written option perfectly matched. The IFRIC was asked whether IAS 39 allows such an approach.
> The IFRIC noted that the following questions have to be considered in addressing the issue:
> (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.
> Regarding question (a), IAS 39 requires the hedged item used for assessing and measuring hedge effectiveness to be the same as that designated at the inception of the hedge (see IAS 39 paragraph 88).
> Regarding question (b), IAS 39 does not allow derivatives to be designated as hedged items subject to one exception, namely a purchased option in a fair value hedge (see the answer to Question F.2.1 of the Guidance on Implementing IAS 39). Therefore, the IFRIC noted that a (hypothetical or actual) written option cannot be designated as a hedged item under IAS 39.
> Moreover, the IFRIC noted that the approach suggested in the requests 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.
> In view of the above requirements, the IFRIC noted the approach suggested in the requests is not allowed under IAS 39. Therefore, the IFRIC [decided] not to take the issue on to its agenda.

4. However the IFRIC did not finalise its agenda decision because of the pending publication of the ED.

5. The decision of the Board in developing the ED (paragraph AG99E) was consistent with the view of the IFRIC, as set out in the draft IFRIC rejection wording.

Paragraph AG99E states that:

[1] A 'hypothetical derivative' is a derivative whose changes in fair value match (replicate) perfectly the changes in fair value of the hedged item for variations in the risk being hedged. Thus, the hypothetical derivative would be expected to perfectly match (replicate) the hedged cash flows

> In designating as a hedged item a portion of a financial instrument, an entity cannot specify as the hedged item a cash flow that does not exist in the financial instrument as a whole. For example, in designating a one-sided risk (such as the decrease in the fair value of a financial asset) as a hedged portion, an entity cannot include any cash flows that are imputed or inferred in the designated hedged portion (for example, inferring the cash flows arising from the time value of a hypothetical written option in a non-derivative financial asset).

6. The Board believed that this decision reflected its original intentions. However, the Board acknowledged in the ED that diversity in practice exists and that paragraph AG99E may result in a change in practice for some entities. This has been confirmed by some respondents to the ED.

7. The appendix to this paper illustrates the approach set out in the submission to the IFRIC.

STAFF RECOMMENDATION

8. The staff recommends:
   a) retaining the approach taken in the ED with regards to this issue
   b) retaining paragraph AG99E of the ED in application guidance of IAS 39
   c) some minor drafting changes to clarify that paragraph, and
   d) re-emphasising the principles underlying hedge accounting in the Basis for Conclusions (BC).

STAFF ANALYSIS

9. Respondents to the ED raised a number of concerns regarding paragraph AG99E. These included:

   a) *Hedged item:* IAS 39 permits a one-sided risk to be designated as the hedged item – for example, the risk that the exchange rate will exceed a specified rate. Paragraph 86(b) of IAS 39 defines a cash flow hedge as a hedge of the variability in cash flows attributable to a particular risk, and paragraph 96(a) requires that the cumulative change in fair value of the expected cash flows are considered. The hedged risk is a one-sided risk. The change in fair value of one-sided cash flows should include the possibility that, even if the exchange rate (or other variable) is below a 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.

b) *Effectiveness and hypothetical derivative approach:* Effectiveness of the approach set out in (a) can be modelled using a hypothetical written option (the hypothetical derivative approach is explicitly permitted in IAS 39 and an example involving a hypothetical forward contract is set out in paragraph IG F.5.5 of IAS 39). However, the designated hedged item is not the hypothetical written option, and the hypothetical written option is simply the mechanism used to replicate the change in fair value of the forecast cash flows for the hedged one-sided risk.

c) *DIG G20 Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge:* Some respondents note that DIG G20 explicitly permits the approach in the submission. Such respondents argued that the not permitting such an approach would create divergence with US GAAP.

d) *Scope and clarity of paragraph AG99E:* Some respondents also suggested drafting changes to clarify paragraph AG99E, and that the Board should clarify whether paragraph AG99E applies to both financial and non-financial hedged items.

Staff comments – meaning of 'one-sided' risk

10. The staff notes that arguments presented by respondents are similar to the arguments discussed at the IFRIC. However the most important issue in the staff's view is what the Board means by a 'one-sided' risk.

11. The hedge accounting model in IAS 39 is based on a principle of offset. That is, the hedge is expected to be, and does, achieve largely offsetting changes in fair value or cash flows between the designated hedged item and hedging instrument.

12. Let us consider those offsetting changes between the hedging instrument and hedged item.

13. First of all, let us take the hedging instrument. Any option has a premium. If you buy an option, you pay a premium. That is a cash flow. Unless the option is deeply in-the-money, most of that premium will be 'time value'.

14. Then take the hedged item. This hedged item (for example, a highly probable forecast sale) has no optionality. It will happen (or at least, you are almost certain that it will occur). Such a hedged item does not have the equivalent of 'time value'; that is, such an item has no cash flow to offset the time value component of the premium cash flow of a purchased option. The simple example set out in the appendix illustrates this lack of cash flow offset.

15. Paragraph 74 (a) of IAS 39 allows an entity to separate the intrinsic value and time value of an option contract and to designate only the intrinsic value of an option as a hedging instrument. This is an exception to the principle that a hedging instrument must be designated in a hedge accounting relationship in its entirety. Applying paragraph 74(a) results in changes in the time value of the designated option being recognised in profit or loss.

16. Paragraph 74(a) is consistent with the principle of offsetting (or nearly offsetting) changes in fair value or cash flows between the designated hedged item and hedging instrument being necessary before hedge accounting may be applied. If a one-sided risk is designated then all of the cash flows are being hedged, but only for the effect of a change in exchange rates (for example) within a particular range. If exchange rates are actually within that particular range, cash flow variability from the hedged item arises; this cash flow variability will be offset by changes in the intrinsic value of the purchased option designated as a hedging instrument – and hence the principle of offset is met.

17. Paragraph IG F1.10 of IAS 39 illustrates the designation of an out-of-the money put option as the hedging instrument of an equity investment. In the staff's view, that example is clear that the analysis set out in the preceding paragraphs is appropriate, and that the term 'one-sided risk' is a hedge of all of the fair value, but only for variability in all of the fair value above or below a particular exchange rate or price. That is, if the hedged cash flows do not contain any optionality (time value), IAS 39 does not permit any to be inferred.

18. Some respondents argued that such an approach does not reflect their economic use of options as a hedging instrument. That may be true, but could equally be applied to many

other situations. Hedge accounting is an exception to the normal accounting rules for derivative (and other hedging) instruments. An exception has to have some boundaries. Setting a boundary is inevitably going to be somewhat arbitary. The staff believes that using a principle of offset between the hedged item and hedging instrument is a good boundary to draw.

Staff comments – use of a hypothetical derivative

19. A hypothetical derivative approach is cited by IAS 39 as being one among many possible ways to measure effectiveness. Indeed, for some cash flow hedges, such an approach may be the *only* possible method.

20. However, a hypothetical derivative used to measure effectiveness must replicate the hedged cash flows. If the one-sided risk of the hedged cash flows contain no optionality (time value) as discussed in the previous section, then the hypothetical derivative must contain no optionality (time value). That is, a discussion about the design or use of a hypothetical derivative approach to measure effectiveness is pointless until the characteristics of the hedged cash flows are determined.

Staff comments - DIG G20 *Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge*

21. Some respondents noted that paragraph AG99E of the ED would *create* divergence from US GAAP.

22. The staff agrees that US GAAP permits the designation of a purchased option in a cash flow hedge in the way that no ineffectiveness is created. However, the staff believes that this is an exception to the principle of offset that underlies the hedge accounting models in both US GAAP and IFRS. The staff notes that such an exception was never given in IAS 39 (despite having been discussed on a number of occasions at the IAS 39 Implementation Guidance Committee), and the staff believes therefore that AG99E of the ED does not *create* divergence from US GAAP, because such divergence in this particular area has always existed.

Staff comments – drafting and clarity of paragraph AG99E

23. The staff proposes including application guidance in IAS 39 to clarify the meaning of a one-sided risk and to explicitly prohibit the designation of cash flows associated with the probability of occurrence of a risk. The drafting will incorporate many helpful suggestions by some respondents to the ED, and will also make it clear that the application guidance regarding the designation of one-sided risks applies to all hedge accounting relationships – including those involving non-financial items.

Questions for the Board

Does the Board agree with the staff recommendation in paragraph 8? If not, what does the Board wish to do, and why?

Appendix – simple illustration

Background

- An entity purchases a 2 year foreign currency option to hedge against a foreign currency exposure arising from a forecast transaction in 2 years time.
- The purchased option has the same notional amount as the forecast transaction.
- The option is 'out-of-the money' and the entity pays a premium of CU10.
- The premium of CU10 is 'time value'.
- Assume that the option is never subsequently 'in-the-money'.
- Assume that the fair value of the option is CU6 at the end of year 1, and that the option expires unexercised (and worthless) at the end of year 2.

Approach suggested in the IFRIC submission

- The entity designates the purchased option in its entirety as hedging the probability adjusted variability in future cash flows arising from changes in foreign exchange rates (that is, capturing the possibility that the option may or may not be 'in-the-money' in the future, which takes into account expected volatility of foreign exchange rates).
- Because the forecast exposure has the same maturity date and notional amount as the purchased option, the approach suggested to the IFRIC assumes that the hedging relationship is fully effective. Therefore subsequent changes in the fair value of the option premium are recognised in other comprehensive income.
- At the end of year 1, the change in fair value of the option (CU4) is recognised in other comprehensive income.
- At expiry of the option (2 years time), the change in the fair value of the option (CU6) is recognised in other comprehensive income and cumulative change in the fair value of the option (CU10) is reclassified from equity to profit or loss as a reclassification adjustment.
- The forecast transaction occurs, and there is no offsetting cash flow variability arising from the hedged risk.
- The example is summarised in the following table.

Summary

	Submission to IFRIC	
	Year 1 (CU)	*Year 2 (CU)*

Purchased option (hedging instrument)		
OCI	4	6
Reclassified to P&L	0	10
Hedged cash flows (hedged item)		
Variability in cash flows from hedged foreign exchange risk	0	0