

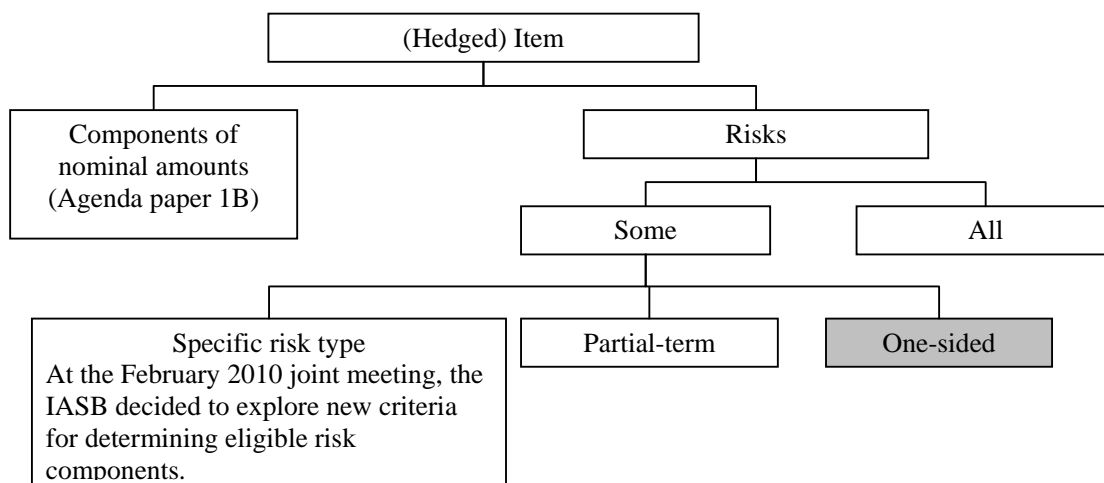


Project **Accounting for financial instruments – hedge accounting**

Topic **Eligible hedged items – one-sided risk components**

Purpose of this paper

1. This paper addresses one-sided risk components. The tree diagram below sets out the various types of components that could be eligible for hedge accounting.



2. **The purpose of this paper is to ask the Board whether one-sided risk components should be eligible for designation as hedged items.**
3. This paper sets out:
 - (a) the issue;
 - (b) staff analysis;
 - (c) staff recommendation; and

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

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- (d) a question to the Board.

The issue

4. A one-sided exposure is reflected by changes in cash flows or fair values above or below a specified level.
5. For example an entity might hedge exposure to a specific type of risk of a financial instrument (eg interest rates) above a pre-determined level (eg above 5%) using an interest rate cap. In this situation an entity hedges some parts of a specific type of risk (ie interest exposure above 5%). An entity might also combine two one-sided hedges of interest rate risk using an interest rate collar and hedge cash flow variability attributable to both interest rates exposure above and below a pre-determined level.
6. Another example is an entity that hedges the risk of a decrease in sale price in a forecast commodity sale (a non-financial item). In this situation, the entity designates the variability of future cash flows arising from price decreases in the forecast transaction. Only cash flow that results from a decrease in price below a pre-determined level are designated as the hedged item.
7. **The issue is whether one-sided risk components should be eligible hedged items.**
8. For reference, Appendix A sets out the relevant paragraphs in IAS 39 relating to the designation of one-sided risk components.

Staff analysis

9. The staff notes that the designation of one-sided risks has not been problematic in practice. As such designations require pre-determination of a specific level above or below which changes in cash flows or fair values are hedged, the hedged component is typically identifiable and measurable.

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10. However, one main issue that relates to the designation of one sided risks relates to the use of options. The staff notes that this issue does *not* relate to the eligibility of one-sided risk components but to the effectiveness of such hedging relationships. Although this issue was raised in the context of the eligibility of a one-sided risk component in a cash flow hedge, the issue relates more broadly to the use of option-based strategies and the treatment of time value under these strategies. The use of options as hedging instruments is an issue that the staff will separately address.
11. The hedging of one-sided exposures such as an increase in price of a forecast purchase (a cash flow hedge), the decrease in equity price below a pre-determined price (a fair value hedge), or the fixing of interest rates within a certain range using an interest rate collar (cash flow hedge) are common risk management activities. Therefore, the staff thinks that one-sided risk components should be eligible for hedge accounting. Moreover, the staff notes that any criteria developed for risk components will be applicable to one-sided risk components as they are a variation of risk components.

Staff recommendation and question to the Board

12. **The staff recommends that the Board permit the designation of one-sided risk components as eligible hedged items.**

Question – Eligibility of one-sided risk components as hedged items

The staff recommends that the Board permit the designation of one-sided risk components as hedged items. Does the Board agree with the staff recommendation?

If the Board does not agree with the staff recommendation, what does the Board prefer instead and why?

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Appendix A

- AG99BA An entity can designate all changes in the cash flows or fair value of a hedged item in a hedging relationship. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a one-sided risk). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, only cash flow losses that result from an increase in the price above the specified level are designated. The hedged risk does not include the time value of a purchased option because the time value is not a component of the forecast transaction that affects profit or loss (paragraph 86(b)).
- AG110A Paragraph 74(a) permits an entity to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option contract. Such a designation may result in a hedging relationship that is perfectly effective in achieving offsetting changes in cash flows attributable to a hedged one-sided risk of a forecast transaction, if the principal terms of the forecast transaction and hedging instrument are the same.
- AG110B If an entity designates a purchased option in its entirety as the hedging instrument of a one-sided risk arising from a forecast transaction, the hedging relationship will not be perfectly effective. This is because the premium paid for the option includes time value and, as stated in paragraph AG99BA, a designated one-sided risk does not include the time value of an option. Therefore, in this situation, there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk.