Introduction

Background and purpose

1. Agenda paper 7A of this meeting discusses the different types of costs of hedging in a wider sense, which fall into the following broad types:

   (a) transaction costs;

   (b) the time value of (net) purchased options; and

   (c) forward points in non-option type hedging instruments.

2. This paper addresses the accounting for the time value of (net) purchased options (see paragraph 1(b) above). Question 10 in the ED's invitation to comment relates to this issue.

3. At its 27 April 2011 meeting, the Board tentatively decided to align the treatment for time value of options and zero-cost collars. Hence, the final requirements for the accounting for time value of options would also apply to zero-cost collars.

4. The purpose of this paper is to ask the Board whether it wants to:

   (a) essentially retain the proposals in the ED (question 1);

   (b) provide additional guidance and examples (question 2);

   (c) include a general 'principle' with an exception (based on the accounting outcomes from the proposals in the ED) (question 3); and

   (d) also retain how an entity can account for the time value of options (if separated from the intrinsic value) as it is today under IAS 39 *Financial Instruments: Recognition and Measurement* (question 4).

Overview of the Board's proposal in the ED

5. The ED addresses the accounting for the time value of options in paragraphs 33 and B67-B69. Paragraphs BC143-BC155 of the Basis for Conclusions provide the rationale for the proposals.

Proposed changes

6. The ED proposes that when an entity separates the time value of the option and designates as the hedging instrument only the intrinsic value element, the changes in the fair value of the time value are accumulated in other comprehensive income (OCI) and recognised in profit or loss depending on the type of hedged item:

   (a) for *transaction related* hedged items: remove from accumulated OCI (AOCI) in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or reclassify into profit or loss when eg hedged sales affect profit or loss); or

   (b) for *time period related* hedged items: reclassify from AOCI to profit or loss on a rational basis over the term of the hedging relationship the part of the aligned time value that relates to the current period.

7. When there is a misalignment between actual time value paid and aligned time value[1] the ED proposes the following:

   (a) If the actual time value is *lower* than the aligned time value the amount recognised in AOCI would be determined by reference to the lower of the cumulative fair value change of:

      (i) the actual time value; and

      (ii) the aligned time value.

[1] Aligned time value is the time value that would have been paid for an option that perfectly matches the hedged item.

Any remainder of the change in fair value of the actual time value would be recognised in profit or loss.

(b) If the actual time value is *higher* than the alignment time value, the differences in the fair value movement between the two time values would be in recognised in profit or loss.

Rationale for the proposals

8. Under IAS 39 today, when an entity separates the time value of the option and designates as the hedging instrument only the intrinsic value element, the time value is accounted for as a trading gain or loss, which can give rise to significant volatility in profit or loss.

9. From a risk management perspective entities typically consider the time value of an option (which is included in the premium paid at inception) as a cost of hedging. Hence, entities typically view the time value of options as cost of obtaining protection against unfavourable changes of prices, while retaining participation in favourable changes (see paragraph 13 of paper 7A).

10. The Board's rationale was that adopting the 'insurance premium' approach to account for the time value of options aligns better with risk management so was consistent with a key objective of the ED.

11. In order to align the accounting with other areas of accounting in IFRSs, the ED proposed different accounting treatment of the time value of options for *transaction related* hedged items (eg the forecast purchase of a commodity regarding commodity price changes) and *time period related* hedged items (eg hedging existing commodity inventory regarding commodity price changes). Under IFRSs:

(a) Some costs of insuring risks are treated as transaction costs that are capitalised into the costs of the insured asset (eg freight insurance paid by the buyer in accordance with IAS 2 *Inventories* or IAS 16 *Property, Plant and Equipment*)—the proposed accounting treatment for *transaction related* hedged items is consistent with this treatment.

(b) Some costs of insuring some other risks are recognised as expenses over the period for which the entity is insured (eg fire insurance for a building)—the proposed accounting treatment for *time period related* hedged items is consistent with this treatment.

The Board considered that aligning the accounting for the time value of options with such other areas would provide more comparable results that would also be more aligned with how preparers and users think about the issue.

12. To avoid treating the time value of an option like an insurance premium when the time value paid does not *solely* relate to the hedged item, the ED proposes the following:

(a) If the actual time value[2] is *higher* than the aligned time value[3] at inception of the hedging relationship, the entity pays a premium that exceeds the true cost of hedging. Hence, the ED proposes that the amount that is recognised in AOCI should be determined only on the basis of the aligned time value whereas the remainder of the actual time value should be accounted for as a derivative.

(b) If the actual time value is *lower* than the aligned time value at the inception of the hedging relationship, the entity actually pays a lower premium than it would have to pay to cover the risk fully. In order to avoid accounting for more time value of an option than was actually paid, the ED proposes that the amount that is recognised in AOCI would have to be determined by reference to the lower of the cumulative fair value change of:

(i) the actual time value; and

(ii) the aligned time value.

[2] The initial time value of the purchased option.
[3] The time value that would have been paid for an option that perfectly matches the hedged item.

Feedback from comment letters and outreach activities

13. The comment letter feedback:

    (a) mostly agreed with the 'insurance premium' view; but

    (b) views were mixed in regards to the added complexity of the proposals.

14. Those who agree with the proposal did so on the basis of the same rationale as that set out in the Basis for Conclusions.

15. Many who disagree with the proposals did so because of increased complexity rather than because they disagreed conceptually. Those who disagreed commonly cited two areas of complexity:

    (a) the requirement to differentiate between *transaction related* and *time period related* hedged items; and

    (b) the requirement to measure the fair value of the aligned time value.

    Other respondents acknowledge that the proposal adds complexity but think that the benefits outweigh the costs and that the proposals provide logically the correct accounting outcomes.

16. Some respondents did not agree with the proposed accounting for *transaction related* hedged items. Some argue that time value should always be expensed over the option period.

17. The outreach feedback was largely consistent with the comment letter feedback:

    (a) Most participants in the outreach were also supportive of the proposed change to the accounting for time value of options. They agreed that the 'insurance premium' view aligns with the risk management perspective on the time value of options.

    (b) A few participants were concerned about the complexity of the requirement to measure the fair value of the aligned time value.

18. The main issues that respondents suggested to be addressed by the redeliberations are:

(a) **A single accounting treatment:** the Board was asked to consider requiring a single accounting treatment and removing the differentiation between *transaction related* and *time period related* hedged items.

(b) **A single principle and additional guidance/clarification**: the Board was asked to clarify that the underlying common principle is the matching of the option expense with the period in which the hedged transaction or item affects profit or loss.

(c) **Alignment with US GAAP**: the Board was asked to consider aligning the final requirement with that of US GAAP.

(d) **Aligned time value:** the Board was asked to consider simplifying the requirement to account for the fair value of the aligned time value.

19. The feedback from comment letters and outreach activities did *not* oppose the use of OCI in recognising the changes in the fair value of the time value of options. Almost all respondents support the use of OCI to reconcile the difference between the fair value changes of the option's time value (because options are measured at fair value) and the accounting outcomes under an 'insurance premium view' (such as amortisation of the option's time value or including it in the cost of the hedged item or transaction).

Staff analysis

Support for the 'insurance premium' view

20. Most respondents support the 'insurance premium' view for accounting for the time value of options. They think that the proposal provides better communication of the performance and effect of the entity's risk management strategy than under IAS 39 today. In their view the proposal alleviates undue profit or loss volatility and reflects the economic substance of the transaction. They agree that costs of hedging should be associated with the hedged item rather than being (mis)characterised as hedge ineffectiveness.

21. A small minority of respondents disagree with the insurance premium view. One argument cited was that unlike insurance contracts, options could not be cancelled and the insurance premium be recovered from the insurer. That meant that the time value paid could not be recovered and hence it should not be treated like a prepaid asset like insurance premiums.

22. The staff note that whether on cancellation of the insurance contract the premium paid would be recoverable depends on the contract's terms and conditions for refunds (eg notice periods, cancellations penalties or whether refundable at all). In contrast, an option's time value can be recovered through the sale of the option. In fact, in practice options are normally not exercised early but instead sold because that allows the holder to recover the remaining time value.

23. Hence, the staff disagree with the argument that the time value of an option is not recoverable whereas an insurance premium could be recovered.

Should time value be expensed over the life of the option?

24. A few respondents are of the view that the time value paid should not be deferred. They are of the view that the time value paid should be expensed as it cannot be recouped. Many of those respondents who think that time value paid should not be deferred suggest that the more appropriate accounting treatment is to *always* amortise the time value paid over the *life of the option*. In contrast the ED proposes that for *time period related* hedged items the time value would be amortised to profit or loss on a rational basis—in simple situations this would be over the life of the option but often it would not, as illustrated in the examples below.

25. The staff note that such an accounting treatment provides an outcome that does not align with the insurance premium view.

Example A

26. Entity A hedges the variability of interest cash flows arising from the forecast issuance of a 3 year variable interest rate bond in a year's time (t1) with a single purchased interest rate cap. This is a forward start cap that protects against increases in interest rates above the strike price between t1 and t4. The time value paid on inception (t0) for the interest rate cap is 100. If the time value is expensed over the life of the option, 100 will be expensed over 4 years even though the protection from rising interest rates is only for 3 years (from the end of t2 to t4). This would result in the following expense profile:

Time value paid	100				
Time	**t0**	**t1**	**t2**	**t3**	**t4**
Interest expense		n/a	x	x	x
Hedge adjustment		n/a	y	y	y
Time value expense:					
'Life of option' approach		25.0	25.0	25.0	25.0
Under ED proposals		n/a	33.3	33.3	33.3

27. Interest expense on the bond would be recognised over its life in the periods ending from t2 to t4 (variable interest denoted as 'x'). Any intrinsic value from the option would affect interest expense over the same periods, ie limit it to the strike price of the cap (denoted as 'y'). The proposals in the ED would result in expensing the costs of purchasing the cap also over those periods (resulting in additional expense of CU33.3[4] for each period in which interest expense is recognised).

28. In contrast, an approach that recognises the costs of purchasing the cap over the life of the option would result in an expense in the period ending in t1 even though neither interest expense is recognised in this period nor any intrinsic value of the cap.

[4] In this paper, monetary amounts are denominated in 'currency units (CU)'.

Example B

29. Instead of purchasing a single interest rate cap with a blended uniform strike price for all periods ending from t2 to t4 an entity could also use a different strategy and hedge each period individually by buying individual caps (sometimes called 'caplets') for each period. These could for example have the following time values:

Caplet	Expiry	Time Value paid
1	t2	25
2	t3	30
3	t4	45

If the time value of each caplet is expensed over the life of each cap, the profit or loss for periods t1 to t4 would be as follows:

Period	Expense
t1	12.5+10+11.3=33.8
t2	12.5+10+11.3=33.8
t3	10+11.3=21.3
t4	11.3

This results in a declining expense pattern from period t1 to t4:

Time value paid (by period)			25	30	45
Time	**t0**	**t1**	**t2**	**t3**	**t4**
Interest expense		n/a	x	x	x
Hedge adjustment		n/a	y	y	y
Time value expense 'Life of option' approach		33.8	33.8	21.3	11.3
Under ED proposals		n/a	25.0	30.0	45.0

30. As in Example A, interest expense on the bond would be recognised over its life in the periods ending from t2 to t4 (variable interest denoted as 'x'). Any intrinsic value from the option would affect interest expense over the same periods, ie limit it to the strike price of each of the caplets that relates to that period (denoted as 'y'). The proposals in the ED would result in expensing the costs of purchasing each caplet in the period that the caplet relates to. This results in an additional expense for each period in which interest expense is recognised that reflect the costs of obtaining protection for that particular period.

31. In contrast, an approach that recognises the costs of purchasing the caplets over the individual life of each of the options would result in a declining expense pattern from period t1 to t4, reflecting the amortisation of the costs of three caplets in the first two periods and then the amortisation of only two and one caplet in the following periods. It would also result in an expense in the period ending in t1 even though neither interest expense is recognised in this period nor any intrinsic value of the cap.

32. Hence, the highest expense is recognised in periods for which no protection was obtained (ie the period ending t1) or for which protection was cheapest to obtain (ie the period ending t2). This creates a systematic mismatch between when the costs for obtaining protection are recognised and when the entity benefits from that protection (ie when being exposed to the variable interest payments).

33. In the staff's view the accounting under the ED reflects how the entity would obtain the benefits of its hedging strategy—protection from rising interest rates from t2 to t4. Hence, the staff think that *always* expensing the time value paid over the *life of the option* would often distort profit or loss between periods. Under that accounting treatment the time value paid would often not affect profit or loss in the same period as the hedged item. This would create an accounting mismatch (see paragraph 32). It would also be inconsistent with the objective of hedge accounting because it does not faithfully represent the purpose and effect of the costs of hedging.

34. Moreover, the staff consider that the accounting treatment under the ED would be consistent with hedge accounting for interest rate risk using swaps with a blended rate versus individual forward contracts for each interest period (see IG F.5.5 of IAS 39). That also results in recognising forward points on a blended basis for swaps that cover several different periods with a single blended rate whereas using individual forward contracts results in recognising the forward points separately for each individual period.

Example C

35. An entity hedges the forecast purchase of oil on 1/1/X3 by entering into a call option on 31/12/X1 that matures on 1/1/X3. The call option has a strike price of CU100. It pays a premium of CU10.

36. The oil prices increases to CU125 on 31/12/X2 (reporting date) and remains unchanged the next day 1/1/X3. The entity purchases the oil on 1/1/X3 and has a gain (intrinsic value) on the call option of CU25. The entity uses the oil so that it becomes an expense on the same day. The resulting profit or loss pattern is as follows:

Time value paid	10			
Strike price	100			
Time		**31/12/X1**	**31/12/X2**	**1/1/X3**
Time value		10	0.0	0.0
Intrinsic value		0.0	25.0	25.0
Oil spot price		90.0	125.0	125.0
'Life of option' approach:				
Time value expense		0	10	0
Gain from intrinsic value				<25>
Cost of oil at spot price				125
Total cost		0	10	100
Under ED proposals:				
Time value expense		n/a	0	10
Gain from intrinsic value				<25>
Cost of oil at spot price				125
Total cost		0	0	110

37. In this (deliberately extreme) example the entire cost for the time value of the option is expensed in financial year X2. Conversely, the benefit from the gain on the call option's intrinsic value is entirely recognised in financial year X3. When expensing the cost of the option over its life the reduction in the cost of the oil in X3 is overstated because it reflects the full benefit of the price ceiling that the call option provided (ie that the entity would not pay more than CU100) but omits the costs of the adjustment of the purchase price profile.

38. In contrast, the proposals in the ED show the overall cost including all effects of the hedging strategy (sometimes referred to as 'total cash cost'). This means that the reduction of the purchase price of CU25 involved CU10 costs of obtaining the protection against price increases. Hence, the costs are in total CU110 (spot price capped at CU100 plus CU10 paid for the option's time value).

Conclusion

39. The staff note that the proposals in the ED do not defer any amount that cannot be recouped. The ED proposes that for *transaction related* hedged items if all or a portion of the time value paid is not expected to be recovered, that amount would have to be reclassified into profit or loss as a reclassification adjustment. For *time period related* hedged items, the time value paid that is not yet amortised is immediately reclassified into profit or loss at the time of hedge discontinuation.

40. The staff consider that under the insurance premium view the time value paid should affect profit or loss in a manner consistent with the related hedging activity rather than *always* being recognised as hedge ineffectiveness or expensed over the life of the option *even if* it is unrelated to how the hedged exposure affects profit or loss.

41. Many users also agree with the above view, for example analysts in the airline industry typically prefer to see the fuel expense based on what is sometimes called the 'all in cash cost' of the fuel (ie after hedging and the related costs). It reflects a preference that the timing of recognition in profit or loss for the time value should be consistent with that for the intrinsic value.

A single accounting treatment

42. Some respondents argue that the proposals are too complex because they require entities to differentiate between *transaction related* and *time period related* hedged items. Some respondents note that systems have to be set up to deal with two accounting treatments. These respondents suggest that one way of reducing complexity is a single accounting treatment for *transaction related* and *time period related* hedged items.

43. The staff note that the proposed different accounting reflects that entities use options as hedging instruments to achieve different hedging objectives. For example:

(a) objective A: to protect (limit) the future purchase price of a forecast purchase of a commodity; or

(b) objective B: to protect future interest payments against rising interest rates over time.

44. The different accounting outcome in the ED is aligned with other areas in IFRSs that determine how costs for insuring risks are treated and provide more comparable results (see paragraph 11). The staff also note that the different accounting outcomes are consistent with how preparers and users in the outreach thought about the issue.

45. For *transaction related* hedged items, the time value paid is deferred in OCI in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when eg hedged sales affect profit or loss). Only a few respondents disagreed with this accounting. These respondents argue that time value paid is a hedging expense and should not be deferred but should be amortised over the life of the hedging relationship like for *time period related* hedged items.

46. The staff think that amortising the time value paid over the hedging relationship for *transaction related* hedged items distorts profit or loss between periods. The time value paid would not affect profit or loss in the same period as the hedged item.

47. The staff further note that using a single accounting treatment for *transaction related* and *time period related* hedged items would be inconsistent with other IFRSs. For example, it leads to accounting that is inconsistent with other areas of IFRSs that relate to the treatment of the cost of insurance (eg freight insurance paid for the acquisition of property, plant and equipment or inventory). Other IFRSs account for insurance costs for a particular transaction differently to insurance for protection over a period of time. The suggested single accounting treatment would essentially treat *unlike* situations as alike. The staff is of the view that this would diminish comparability and hence not be an improvement to financial reporting.

48. The staff also note that the requirements in IAS 39 and the ED result in deferral of gains and losses from *forward contracts* for qualifying hedging relationships, which also includes the forward points (if the 'forward rate method' is chosen) and implied transaction costs (depending on how fair value is positioned within the bid-ask spread—see agenda paper 7A). The staff further note that the ED also includes an impairment test to ensure that the amount deferred on the time value paid is recoverable (see paragraph 39).

A single principle and additional guidance/clarification

49. Some respondents have suggested that instead of explicitly specifying different accounting treatments for *transaction related* and *time period related* hedged items, the Board could consider setting out a principle instead. Some respondents raised concerns about the potential difficulty of determining whether a hedge would be a transaction or time period related one. In response to this some commented that setting out a key principle would also assist in understanding the differentiation between *transaction* and *time period* related hedged items.

50. In the ED, the accounting for time value of options is aligned with other areas of accounting and the risk management perspective (resulting in the 'insurance premium' view). The ED applies different accounting treatments so that the accounting outcome is reflective of how costs of protecting against risk (such as insurance premiums) are accounted for elsewhere in IFRSs (see paragraph BC148 of ED).

51. To clarify the accounting outcome that the ED is trying to achieve, the staff think that a general principle could be set as follows:

> **The change in fair value of the time value of an option shall be recognised in other comprehensive income to the extent that it relates to the hedged item and be accumulated in a separate component of equity.**

> **The timing of recognising in profit or loss the time value paid (to the extent that it relates to the hedged item) shall be consistent with how the intrinsic value of the related hedging relationship can affect profit or loss.**

52. The different accounting treatment in the ED for *transaction related* and *time period related* hedge items would be an application of the above principle. Appendix A sets out different scenarios and demonstrates that the above principle would result in the same accounting outcomes as the ED ***except*** for one scenario—hedges of firm commitments.

53. For a purchase of a commodity that is a firm commitment, the time value of the option would have the characteristic of transaction costs and hence should be deferred and capitalised into the cost of the commodity. However, in a fair value hedge, the intrinsic value (if any) would affect profit or loss during the period of the hedge, so applying the above principle would result in time value paid being amortised over the hedging relationship—an accounting outcome that is inconsistent with other IFRSs.

54. Hence the staff note that although the principle set out above will cover a majority of scenarios, applying the above principle would not provide the appropriate accounting outcome for hedges of firm commitments. If the Board includes that 'principle' in the final IFRS an 'exception' would have to be included for hedges of firm commitments. This may create more confusion than clarification (in particular since there is no exception but only the use of a 'principle' that does not fit would create that misperception).

55. Some respondents have asked the Board to clarify and provide further guidance on how to differentiate between *transaction related* and *time period related* hedged item. Some respondents commented that the Board could consider providing more guidance, clarification and examples for these new terms.

56. Some respondents viewed that the time value paid on options could always be considered as related to a time period (and could hence be confused with *time period related* as used in the ED) as the option provides protection for the option

holder over a period of time. However, the staff note that whether an option is *transaction* or *time period related* relates to the characteristics of the ***related hedged item*** and when that affects profit or loss rather than the hedging instrument.

57. Some respondents also asked for clarification of the period over which the time value paid shall be amortised for *time period related* hedged item if the start date of the option is a date subsequent to the purchase of the option eg the scenario in Example A (see paragraph 26). Respondents have asked for clarification of whether amortisation should begin when the option is purchased or at the date of the debt issuance in that fact pattern.

58. The Board could consider adding a clarification that the period of amortisation does not necessarily have to correspond to the period of the hedging relationship, but should relate to the period over which the hedge adjustment for intrinsic value can affect profit or loss.

59. To assist preparers, the Board could consider providing additional application guidance in the final requirements. For example the Board could consider providing the following additional guidance:

    (a) For hedges where the option is used to provide price protection for an exposure to a particular risk over a period of time (eg to hedge the interest rate expense of a floating rate bond), the hedge adjustment for any intrinsic value would affect profit or loss over that period (ie when the hedged interest payments are recognised in profit or loss), therefore the time value paid should also affect profit or loss over that period *(time period related hedged items)*.

    (b) For hedges where the option is used to provide price protection for an exposure to a particular risk from a particular transaction (eg to hedge the commodity price of a forecast purchase of commodity), the time value paid should also affect profit or loss at the same time as the asset or liability resulting from that particular transaction affects profit or loss *(transaction related hedged items)*.

60. The principle in paragraph 51 aims to clarify the accounting outcome of the ED. It is consistent with the ED and does *not* introduce a new set of accounting outcomes. Hence, as explained in paragraph 52, the principle suggested by the staff still results in a different accounting outcome depending on the type of hedged item. Different accounting outcomes would require different impairment tests. The ED sets out impairment tests for *transaction related* and *time period related* hedged items (see paragraphs 33(b)(iii) and (c) of the ED):

    (a) For *transaction related* hedged items the ED proposes that an entity reclassifies into profit or loss as a reclassification adjustment the amount that is not expected to be recovered—equivalent to the impairment test for the cash flow hedge reserve (see paragraph 39).

    (b) For *time period related* hedged items, if an entity discontinues hedge accounting, the net amount remaining in AOCI shall be immediately released to profit or loss—any time value paid should only be deferred as long as there is an exposure that is hedged.

    The staff think the Board should consider retaining the proposed impairment test.

Alignment with US GAAP

61. Some respondents also suggest that the Board should consider aligning the requirements under IFRSs with those under US GAAP.

62. The staff note that the Board discussed in its deliberations the current and proposed treatment under US GAAP for accounting for the time value of options (see Appendix B of this paper).

63. The current and proposed accounting treatment under US GAAP are based on a view that the time value paid is a hedge ineffectiveness issue. Hence, the deferral of the change in the time value of options is achieved by allowing the hedged item to be measured such that it includes a characteristic that does *not* have (time value of an option) in order to avoid hedge ineffectiveness arising from this difference in characteristics between the hedging instrument and the

hedged item. However, the Board took the view that the time value paid is a cost of hedging and did not share the same view as the US Financial Accounting Standards Board. The staff note that the feedback of most commentators on the ED supported the Board's view.

64. The staff further note that, unless the critical terms of the options are perfectly aligned with the hedged item, the requirements under current US GAAP are not less complicated because the accounting would also involve a second option valuation (for the 'hypothetical option') and a 'lower of' test. In addition, impairment requirements apply. The proposed accounting standards update *Accounting for Financial Instruments and Revision to the Accounting for Derivative Instruments and Hedging Activities* did not provide any specific guidance on the accounting for time value when the critical terms are not aligned.

Aligned time value

65. Some respondents, although they agree conceptually with the insurance premium view, do not support the proposals because they think that the costs of implementing the proposals outweigh the benefits especially for less sophisticated (eg some smaller) entities.

66. These respondents argue that in order to comply with the proposed requirements entities would have to produce an additional option valuation to determine the aligned time value. This valuation is complex, would generally require the involvement of valuation experts and would incur additional costs to preparers. Some respondents argue that the costs required would be significant to smaller entities and may lead to the adverse consequence of entities not using options.

67. However, some large preparers think that the benefit and costs of the ED's proposals significantly outweigh the costs. They consider it provides better information on performance and more faithfully presents the effect of the entity's risk management.

Apply the accounting requirement to the entire amount of actual time value paid

68. To reduce complexity, some respondents suggested that the proposed accounting treatment for the time value of options should apply to the entire amount of the time value paid even if it differs from the aligned time value. This means that entities would not need to compute a separate valuation of the fair value of the aligned time value.

69. However, as discussed in paragraph 12, the Board proposed requiring the fair value of the aligned time value to be measured so that when the time value paid does not *solely* relate to the hedged item, the entire time value paid is not treated like a cost of hedging (an 'insurance premium' view). The Board's view is that only the time value paid that relates to the hedged item should be treated as a cost of hedging, hence any additional time value paid should be accounted for as a derivative at fair value through profit or loss.

Accounting choice?

70. Some respondents have suggested that to reduce the operational burden in complying with the final requirements, the Board should consider providing entities with a choice to account for the time value of options either:

    (i) as proposed in the ED; or

    (ii) in accordance with the current treatment under IAS 39 today.

    Some respondents have suggested that this be an accounting policy choice.

71. The treatment under IAS 39 today does not require an additional option valuation for the aligned time value. Entities that choose to designate only the intrinsic value of an option as a hedging instrument simply recognise in profit or loss the difference between the change in the fair value of the option in its entirety and the change in fair value of the intrinsic value. To comply with the proposals in the ED, two option valuations would be required, whereas under IAS 39 today only one option valuation would be required. Hence respondents

suggest that providing a choice would lessen the operational costs significantly for less sophisticated (eg some smaller) entities.

72. However, as discussed in agenda paper 7A, the accounting treatment under IAS 39 would in effect present the change in fair value of the time value as a trading profit or loss, which is not consistent with its character of costs of hedging.

73. Also, by offering an accounting choice this could impair comparability between entities and make financial statements more difficult to understand. To mitigate this to some extent, the Board could consider introducing this choice as an *accounting policy choice* for entities, so that the time value of options is accounted for in the same way for all options designated as hedging instruments if the entity chooses to designate only the intrinsic value as the hedging instrument. While this would not address the issue of comparability between entities it would at least ensure comparability for all like transactions for a particular preparer.

Wording issue

74. A few respondents suggest that the aligned time value appears to be the time value of a hypothetical derivative and recommend such wording be used rather than introducing new terminology—aligned time value. The staff note that a hypothetical derivative is a particular concept that already exists in hedge accounting literature to describe a derivative whose terms exactly match the *hedged item*. As discussed in paper 7A paragraph 11, most hedged items do not have a corresponding optionality and hence no time value. In the staff's view using that term in this way would be incorrect as the aligned time value is not part of the hedged item and hence a hypothetical option-type derivative would not faithfully represent that hedged item.

Staff recommendation and questions to the Board

Accounting for time value of options

75. Most respondents support the proposals for the 'insurance premium' view (ie cost of hedging) of the time value paid and agree that the accounting outcomes from the ED's proposals reflect the economic substance of the transaction. These respondents agreed that the differentiating accounting outcomes in the ED are aligned with how other costs of protecting against risk such as insurance costs are treated under other areas in IFRSs and provide more comparable results. They also agreed that the ED's proposals provide better communication of the performance and effect of the entity's risk management strategy.

76. Hence the staff recommend that the Board confirms the accounting *outcomes* as proposed in the ED on the accounting for time value of options (ie that there would be two different approaches to recognising the time value of options depending on the nature of the hedged item).

Question 1: Proposals in the ED
Does the Board agree with the staff recommendation in paragraph 76 above? If the Board does not agree, what does the Board prefer instead and why?

77. Respondents have asked for further clarification on the application of the final requirements. The staff considers providing application guidance and clarification would assist preparers in applying the requirements in the intended manner.

78. Hence, the staff recommend that the Board expands the application guidance in the ED (eg provide guidance similar to paragraphs 55, 56 and 58).

Question 2: Additional guidance and examples
Does the Board agree with the staff recommendation in paragraph 78 above? If the Board does not agree, what does the Board prefer instead and why?

79. Some respondents have suggested that the Board could consider setting out a general principle to assist in understanding the difference between *transaction* and *time period* related hedged items.

80. A possible general principle is set out in paragraph 51. The staff note that although this general principle covers a majority of the scenarios, it does not cover all scenarios. If such a principle is added to the final requirements, an exception would be required for hedges of firm commitments.

81. The staff does **not** recommend that the Board sets out a general principle (with an exception for firm commitments). The overarching general principle does not change the accounting outcomes of the proposals in the ED. Adding an overarching general principle with an exception would be likely to cause confusion rather than assist understanding. The staff further note that if the Board agrees with the staff recommendation in paragraph 78 (ie question 2) that the proposed additional application guidance would provide sufficient clarification.

Question 3: Adding a general principle (with an exception)
Does the Board agree with the staff recommendation in paragraph 81 above not to introduce a general principle (with an exception for firm commitments)? If the Board does not agree, what does the Board prefer instead and why?

Accounting choice

82. The staff acknowledge the additional operational burden arising from determining the fair value of the aligned time value and the differentiating accounting treatment in the ED. However the staff note that the treatment under IAS 39 today characterises the time value of an option as a trading gain or loss. This is not a faithful representation of the time value, which is a cost of hedging (the 'insurance premium' view). The staff further note that accounting choices impair the comparability of financial statements.

83. Hence the staff recommend the Board does **not** introduce an accounting choice.

Question 4: Accounting choice
Does the Board agree with the staff recommendation in paragraph 83 not to introduce an accounting choice for the treatment of time value? If the Board does not agree, what does the Board prefer instead and why?

Appendix A

A1. Paragraph 51 sets out a principle for the accounting for time value of options:

> **The change in fair value of the time value of an option shall be recognised in other comprehensive income to the extent that it relates to the hedged item and be accumulated in a separate component of equity.**
>
> **The timing of recognising in profit or loss the time value paid (to the extent that it relates to the hedged item) shall be consistent with how the intrinsic value of the related hedging relationship can affect profit or loss.**

A2. Appendix A sets out different scenarios and demonstrates that the above principle would result in the same accounting outcomes as proposed in the ED—with the exception of hedges of firm commitments (ie scenario 4).

A3. Scenario 1—purchase of a foreign exchange (FX) option to hedge the FX risk of a forecast purchase of property, plant and equipment (PPE).

	ED	**Principle set out in paragraph 51**
Accounting for the time value paid	**Hedged item:** forecast purchase of PPE—*transaction related* **Accounting:** capitalise the time value paid into the PPE as a basis adjustment and recognise in P/L through depreciation expense	**Intrinsic value:** capitalise into PPE as a basis adjustment, hence affects P/L through depreciation expense **Accounting:** capitalise into PPE as a basis adjustment and recognise in P/L through depreciation expense
Same as ED?		√

A4. Scenario 2—purchase of an interest rate cap to hedge the interest expense of a forecast issuance of a 3 year variable interest rate bond *in a year's time*

	ED	**Principle set out in**

		paragraph 51
Accounting for the time value paid	**Hedged item:** interest expense from the bond from beginning of t2 to end of t4—*time period related* **Accounting:** amortise to P/L the time value on a rational basis from beginning of t2 to end of t4	**Intrinsic value:** would affect interest expense over the life of the bond **Accounting:** amortise to P/L the time value on a rational basis from beginning of t2 to end of t4
Same as ED?		√

A5. Scenario 3—purchase of a commodity option to hedge the price risk of a forecast purchase of a commodity (cash flow hedge of a forecast transaction)

	ED	**Principle set out in paragraph 51**
Accounting for the time value paid	**Hedged item:** forecast purchase of a commodity—t*ransaction related* **Accounting:** capitalise the time value paid into inventory as a basis adjustment and recognised in P/L at the same time as the sale of the commodity inventory	**Intrinsic value:** capitalise into inventory as a basis adjustment, hence affects P/L at the same time as the sale of the commodity inventory **Accounting:** capitalise the time value paid as a basis adjustment into the inventory and recognise in P/L at the same time as the sale of the commodity inventory
Same as ED?		√

A6. Scenario 4—purchase of a commodity option to hedge a firm commitment to purchase a commodity (against fair value risk)

	ED	**Principle set out in paragraph 51**

Accounting for the time value paid	**Hedged item:** firm commitment to purchase a commodity—*transaction related* **Accounting:** capitalise the time value paid into inventory as a basis adjustment and recognise in P/L at the same time as the sale of the commodity	**Intrinsic value:** would affect P/L over the period of the hedging relationship **Accounting:** amortise to P/L over the period of the hedging relationship
Same as ED?		×

A7. Scenario 5—purchase of a commodity option to hedge the existing commodity inventory regarding commodity price changes

	ED	**Principle set out in paragraph 51**
Accounting for the time value paid	**Hedged item:** existing commodity inventory—*time period related* **Accounting:** amortise to P/L the time value on a rational basis	**Intrinsic value:** would affect P/L over the period of the hedging relationship **Accounting:** amortise to P/L over the period of the hedging relationship
Same as ED?		√

Appendix B—Extract from agenda paper 4A of 27 October 2010 meeting

US GAAP and FASB proposed ASU

24. For particular cash flow hedges that involve a purchased option as the hedging instrument US GAAP allows considering the hedging relationship to be perfectly effective, if certain conditions that essentially relate to the alignment of critical terms are met.[5] If considered perfectly effective all fair value changes of the option—including its time value—are simply recognised in OCI and hence no hedge ineffectiveness is recognised in profit or loss.[6] This results in the deferral of the time value of the option in accumulated OCI, which is reclassified into profit or loss in the period(s) in which the hedged forecast transaction affects profit or loss.

25. If the conditions that essentially relate to the alignment of the critical terms of the purchased option and the hedged forecast transaction are not met the hedge cannot be considered perfectly effective. In that case hedge ineffectiveness is determined by comparing the fair value changes of:

    (a) the actual purchased option in its entirety (hedging instrument); and

    (b) a perfectly effective hypothetical hedging instrument, which is an option that would have critical terms that are fully aligned with the hedged forecast transaction; the fair value changes on this hypothetical derivative can be regarded as a proxy for the changes in the value of the expected cash flows of the hedged item.[7]

26. However, this accounting treatment for the time value of an option does not apply to fair value hedging relationships.[8]

---

[5] See ASC 815-20-25-126 to 129.
[6] See ASC 815-30-35-33 and 815-20-25-129.
[7] See ASC 815-30-35-33 to 34.
[8] See ASC 815-30-35-37 and 815-20-25-127.

27. Under the proposed accounting standards update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the ASU) the treatment of the time value of options would change. The proposals would require reclassifying from OCI to profit or loss 'each period on a rational basis an amount that adjusts net income for the amortization of the cost of the option'[9] instead of accumulating the time value in OCI over the term of the hedging relationship.

28. The basis for conclusions of the ASU says that the FASB believes the time value of an option represents *hedge ineffectiveness*. However, the FASB decided to allow deferral of the recognition of the option's time value using an amortisation approach in order to simplify the cash flow hedging model and align it with how an option's time value is treated under the foreign currency cash flow hedging model.[10]

[9] See ASU.125.
[10] ASU.BC231.