

Project

Financial Instruments (Replacement of IAS 39)—Hedge accounting

Topic

Options as hedging instruments—Cover paper

Background

1. In the ED, the Board proposed a change to the accounting for the time value of options under IAS 39 *Financial Instruments: Recognition and Measurement*. The proposals reflect the view of a premium for protection against risk ('insurance premium' view). Question 10 in the ED's invitation to comment relates to this issue.
2. In commenting on question 10 of the ED, respondents have also raised the following issues that relate to that question:
 - (a) the accounting for other types of costs of hedging (eg forward points and transaction costs); and
 - (b) that paragraph 11 of the ED prohibits designating as a hedging instrument a written option in combination with a purchased option.

These two issues have also been raised by participants in the outreach activities.
3. This paper series contains three papers addressing the comments on question 10 of the ED and the issues raised in the comment letters and outreach:
 - (a) Agenda paper 7A: costs of hedging.
 - (b) Agenda paper 7B: accounting for the time value of options.
 - (c) Agenda paper 7C: designating as the hedging instrument a written option in combination with a purchased option.

This paper has been prepared by the technical staff of the IFRS Foundation 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 IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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4. Agenda paper 7A discusses the types of **costs of hedging** generally. Agenda paper 7B discusses one of these types of costs of hedging—time value of options (question 10 of the ED).
5. Agenda paper 7C discusses another aspect of options and is unrelated to paper 7A. It discusses the **eligibility** of options for designation as hedging instruments.

Costs of hedging—agenda paper 7A

6. Agenda paper 7A provides the background and context for the Board to think about the question of how the costs of hedging should be accounted for. It discusses the following types of costs of hedging:
 - (a) transaction costs;
 - (b) the time value of (net) purchased options; and
 - (c) forward points in non-option type hedging instruments.
7. This paper does not ask the Board any questions.
8. The Board began some discussions on forward points (see 6(c) above) at the April 2011 meeting. At that meeting, the Board did not make decisions but discussed the current accounting for funding swaps under IAS 39 and started to explore possible alternatives (eg extending the treatment proposed in the exposure draft for the time value of options to forward points) to better reflect the economics of such transactions¹.

Time value of (net) purchased options—agenda paper 7B

9. Agenda paper 7B discusses the accounting for the time value of (net) purchased options as proposed in the ED (question 10 of the ED).

¹ The Board noted that the current accounting requirement under IAS 39 might not reflect the economics of such transactions.

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10. At its 27 April 2011 meeting, the Board tentatively decided to align the treatment for time value of options and zero-cost collars. The final requirements for the accounting for time value of options would therefore also apply to zero-cost collars.
11. Agenda paper 7B provides:
 - (a) a summary of the feedback from comment letters and outreach activities on the proposals in the ED on the accounting for the time value of options;
 - (b) staff analysis of the feedback; and
 - (c) staff recommendation and questions to the Board.
12. Agenda paper 7B asks the Board four questions:
 - (a) whether the Board wants to essentially retain the proposals in the ED;
 - (b) whether the Board wants to provide additional guidance and examples;
 - (c) whether the Board wants to include a general principle with an exception (based on the accounting outcomes from the proposals in the ED); and
 - (d) whether the Board also wants to 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*.

Designation as a hedging instrument of a written option in combination with a purchased option—agenda paper 7C

13. Agenda paper 7C discusses another aspect of options—designating options as hedging instruments. The comment letter and outreach feedback requested that in finalising in the hedge accounting requirements the Board to amend paragraph 11 of the ED regarding designating a written option in combination with a purchased option as the hedging instrument. This paper asks the Board one question.