

The cuffs come off



MICHELLE PRICE AND KUSH PATEL EXAMINE THE IASB'S PROPOSED CHANGES TO THE HEDGE ACCOUNTING RULES, WHICH COULD LEAD TO A REVIVAL IN THE USE OF OPTIONS AS HEDGING INSTRUMENTS.

The international accounting rules for derivatives have long been a thorn in the side of corporate treasurers, with the complex rules having had a significant impact on the risk management practices of companies that apply them. Now, just as the world has got used to the vagaries of the current regime, the International Accounting Standards Board (IASB) is set to rewrite the rulebook. In December, it issued an exposure draft for hedge accounting, which currently resides in the infamous accounting standard IAS 39: Financial Instruments: Recognition and Measurement. At this stage, the draft contains just proposals. But they are due to be finalised by mid-2011, for mandatory application from 2013. Should treasurers be worried?

The effects of the new regime would vary between different organisations. Sir David Tweedie, chairman of the IASB, says: "These proposals sweep away the existing rule-based, complex and inflexible hedge accounting requirements and replace them with a simple, principle-based approach. The result, if adopted, will be a much simpler model that better reflects risk management practices while providing more useful information to investors."

For many corporates it could mean a rethink of risk management policies and accounting decisions.

In this article, we explore the possible effects on hedging strategies involving financial options. The use of financial options was curtailed by many corporates when IAS 39 was originally introduced and the new proposals may see the pendulum swing back in their favour. Other proposed key changes to hedge accounting have been summarised in the table opposite.

CURRENT ISSUES UNDER IAS 39 Financial options come in all shapes and sizes. From plain-vanilla puts and calls to more structured products with combinations of options and exotic features. But the basic accounting requirement is the same: mark to market through profit or loss. For those that wish to limit the ensuing volatility in profit or loss there is the potential alternative of hedge accounting but in many cases the outcome has been suboptimal. To qualify for hedge accounting, some strict conditions must be met. In practice, these are more easily met using vanilla non-optional instruments to hedge, such as forwards and swaps. Hedge accounting can be applied for financial options but there can be obstacles that either prevent qualification entirely or allow hedge accounting for only part of the option, so some profit or loss volatility remains.

One issue in IAS 39 relates to the different accounting treatment for the two components of the market value of a financial option – the time value and the intrinsic value. Hedge accounting can, in many cases, work for the intrinsic value component of a vanilla option. For example, buying an FX option to sell dollars with a strike price of \$1.5:£1 can usually get hedge accounting (for the intrinsic value component) when hedging a dollar receipt for the risk of a weakening in the dollar beyond the strike price. This is because the intrinsic value of the option can be matched off to the exposure. However, when it comes to the time value component (the amount by which the total option value exceeds the intrinsic value), it does not tend to match off with the underlying exposure. As a result, this component flows through to profit or loss on a mark-to-market basis and hence gives rise to volatility. The chart opposite shows the intrinsic value component of the option value with the difference representing time value (which over time will decay to nil).

Another obstacle to hedge accounting for the intrinsic value component of the option is the "effectiveness" requirement. IAS 39 (as it currently stands) requires an entity to demonstrate an expectation



of offset within a strict range of between 80% and 125%. When hedging with options, only vanilla options easily qualify. Exotic options either do not qualify or require statistical numerical analysis.

One such option is a barrier option. It has a lower premium than a vanilla option because it is active only if the barrier price is or is not reached during its term ("knock-in" or "knock-out"). For example, consider a short barrier FX option in US dollars with a strike price of \$1.6:£1 and a knock-out barrier price of \$1.4:£1. This option is transacted when the market price is \$1.5 ("down and out"). This could be used to hedge a long dollar exposure for a weakening in exchange rates beyond \$1.6:£1 provided the barrier is not reached during the term of the option. If the barrier is reached, the hedging entity could transact in the spot market where rates have improved since the option was transacted.

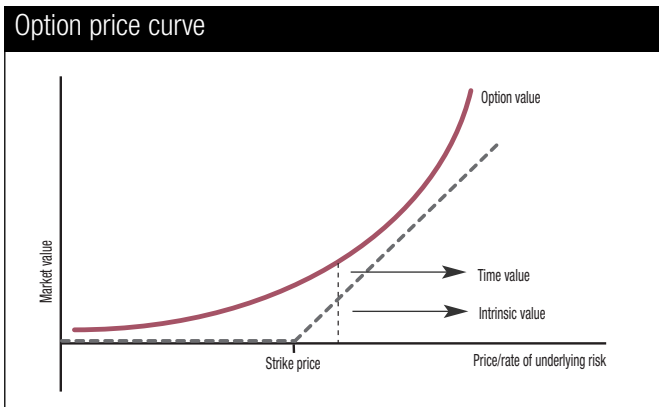
However, if the barrier is reached and the hedging entity does not transact in the spot market and rates subsequently weaken beyond \$1.6:£1, it would not be protected. The lack of protection from the option if the barrier is reached is problematic under IAS 39 because in this case the option would not provide offset between 80% and 125% of the exposure to rate movements beyond \$1.6:£1.

Under the new proposals, the offset requirement is replaced with a requirement for "other than accidental offset". This would mean more types of barrier options could qualify for hedge accounting.

The final issue with hedge accounting for options relates to combinations of purchased and written options. Combining these is another way to reduce the premium payable to buy an option. Although IAS 39 prohibits hedge accounting for written options, if a single instrument combines written options with purchased options it can qualify for hedge accounting provided it is not a "net written option". Even so, in practice this can disqualify genuine risk management strategies and prevent hedge accounting.

THE IASB PROPOSALS The IASB's new hedge accounting proposals go some way to addressing these issues. The accounting for the time value component of an option (when the intrinsic value component is designated for hedge accounting purposes) differs significantly from IAS 39. Instead of recognising the time value change directly in profit or loss, the volatility would hit equity (i.e. directly to reserves). A transfer from equity to profit or loss would then take place on a more predictable basis. In many cases, this would be a one-time hit to profit or loss along with the hedged exposure.

Another proposed change is the removal of the 80% to 125%



offset threshold. In its place a hedge would need to be expected to achieve "other than accidental offset" (i.e. not offset due to luck). This could allow the use of exotic options (such as barrier options) as well as other derivatives that do not consistently achieve offset within the current bands. However, it would not include written options and combinations that are net written options.

Other changes proposed by the IASB include allowing more risks in non-financial items (e.g. transactions to buy or sell non-financial items such as commodities) to qualify for hedge accounting. And while IAS 39 imposes many restrictions on the types of groups of multiple items that can get hedge accounting, the new proposals lift most of these, so allowing hedging with basket options (or index options) that hedge multiple risks.

Overall the effect of the proposed changes could revive the use of options as hedging instruments – as long as the proposals make it into a final standard after the comment period ends on 9 March 2011.

Kush Patel is a senior manager in Deloitte's UK IFRS Centre of Excellence.
kupatel@deloitte.co.uk
www.iasplus.com

Michelle Price is the ACT technical officer.
mprice@treasurers.org

The ACT will be responding to the IASB exposure draft and welcomes comments (both positive and negative) from its members. Please email Michelle Price.

Summary of proposed hedge accounting changes

In addition to the proposed changes to the accounting for financial options, other key changes to hedge accounting include the following:

Effectiveness testing	Replacement of the 80% to 125% effectiveness threshold with an objective-based requirement with no bright lines. In some cases the assessment of hedges for risk management would be sufficient for accounting purposes.
Hedging net positions	Net positions may be hedge-accounted provided that: the individual items are eligible hedged items; the items are managed together on a group basis for risk management purposes; and for cashflow hedges the offsetting cashflows would affect profit or loss in the same reporting period.
Hedging a derivative with a derivative	A derivative can be designated a hedged item if the hedged exposure combines it with a non-derivative.
Hedging non-financial risks	Designation of risk components of non-financial items permitted as long as the risk component is "separately identifiable and reliably measurable". An example is hedging the oil price component of a jet fuel supply contract.