

**DRAFT ENDORSEMENT ADVICE AND EFFECTS STUDY REPORT ON
Amendments to IAS 39 - Novation of Derivatives and Continuation of Hedge
Accounting**

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS

Comments should be sent to commentletters@efrag.org by 11 July 2013

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the *Amendments to IAS 39 Novation of Derivatives and Continuation of Hedge Accounting* ('Amendments to IAS 39'). In order to do that, EFRAG has been carrying out an assessment of the Amendments to IAS 39 against the technical criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the European Union (the EU) and European Economic Area.

A summary of the Amendments to IAS 39 is set out in Appendix 1.

Before finalising its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record, unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

EFRAG initial assessments summarised in this questionnaire will be amended to reflect EFRAG's decisions on Appendix 2 and 3.

1 Please provide the following details about yourself:

- (a) Your name or, if you are responding on behalf of an organisation or company, its name:

- (b) Are you a:

Preparer User Other (please specify)

- (c) Please provide a short description of your activity:

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(d) Country where you are located:

(e) Contact details including e-mail address:

2 EFRAG’s initial assessment of the Amendments to IAS 39 is that they meet the technical criteria for endorsement. In other words, they are not contrary to the principle of true and fair view and they meet the criteria of understandability, relevance, reliability and comparability. EFRAG’s reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

Yes No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG’s endorsement advice.

(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the Amendments to IAS 39? If there are, what are those issues and why do you believe they are relevant to the evaluation?

3 EFRAG is also assessing the costs that are likely to arise for preparers and for users on implementation of the Amendments to IAS 39 in the EU, both in year one and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

The results of the initial assessment of costs are set out in paragraphs 5 to 7 of Appendix 3. To summarise, EFRAG’s initial assessment is that the Amendments to IAS 39 will not result in increased costs to users, i.e., it is likely to be cost neutral.

Do you agree with this assessment?

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Yes No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

- 4 In addition, EFRAG is assessing the benefits that are likely to be derived from the Amendments to IAS 39. The results of the initial assessment of benefits are set out in paragraphs 2 to 4 of Appendix 3. To summarise, EFRAG’s initial assessment is that the overall benefits of not derecognising the hedge accounting relationships are likely to outweigh costs associated with providing this information to users.

Do you agree with this assessment?

Yes No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect EFRAG’s endorsement advice?

- 5 EFRAG’s initial assessment is that the benefits to be derived from implementing the Amendments to IAS 39 in the EU as described in paragraph 4 above are likely to outweigh the costs involved as described in paragraph 3 above.

Do you agree with this assessment?

Yes No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect EFRAG’s endorsement advice?

- 6 EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the Amendments to IAS 39.

Do you agree that there are no other factors?

Yes No

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If you do not agree, please provide your arguments and indicate how this should affect EFRAG’s endorsement advice?

APPENDIX 1

A SUMMARY OF THE AMENDMENTS TO IAS 39

Background

- 1 IAS 39 *Financial Instruments: Recognition and Measurement* requires hedge accounting to be discontinued when the hedging instrument expires or is sold, terminated or exercised (unless the replacement or rollover of a hedging instrument into another hedging instrument is part of the entity’s documented hedging strategy). As such an entity is required to discontinue the hedge accounting for a derivative that has been designated as a hedging instrument in the existing hedging relationship if the derivative is novated to a central counterparty; the new derivatives, with a counterparty being the central counterparty following the new law or regulation, are to be recognised at the time of the novation.
- 2 The widespread legislative changes across jurisdictions were prompted by a G20 commitment to improve transparency and regulatory oversight of over-the-counter (OTC) derivatives in an internationally consistent and non-discriminatory way.

The issue

- 3 The IASB was concerned about the financial reporting effects that would arise from the novation as a result of new laws or regulations, i.e. more hedge ineffectiveness especially for cash flow hedges, compared to a continuing hedging relationship. The IASB, taking note of the financial reporting effects, was convinced that accounting for the hedging relationship that existed before the novation as a continuing hedging relationship in this specific situation would provide more useful information to users of financial statements. The *Amendments to IAS 39 Novation of Derivatives and Continuation of Hedge Accounting* (‘Amendments to IAS 39’) provide relief from discontinuing hedge accounting when novation of a hedging instrument to a central counterparty meets certain criteria. Similar relief will be included in IFRS 9 *Financial Instruments*.

What has changed?

- 4 The Amendments to IAS 39 amend paragraph 91(a) and paragraph 101(a) of IAS 39 and add paragraph AG113A to provide relief from discontinuing hedge accounting when novation of a hedging instrument to a central counterparty meets certain criteria; for this purpose, there is not an expiration or termination of the hedging instrument if:
 - (a) as a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a ‘clearing organisation’ or ‘clearing agency’) or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties this paragraph shall apply only if each of those parties effects clearing with the same central counterparty.
 - (b) other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are

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limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.

When do the Amendments to IAS 39 become effective?

- 5 An entity shall apply those amendments retrospectively for annual periods beginning on or after 1 January 2014. Earlier application is permitted.

APPENDIX 2

EFRAG’S TECHNICAL ASSESSMENT OF THE AMENDMENT AGAINST THE ENDORSEMENT CRITERIA

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on Amendments to IAS 39.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG’s capacity of contributing to the IASB’s due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG’s role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the technical criteria for the European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG’s thinking may evolve.

Does the accounting that results from the application of the Amendments to IAS 39 meet the technical criteria for EU endorsement?

- 1 EFRAG has considered whether the *Amendments to IAS 39 Novation of Derivatives and Continuation of Hedge Accounting* (‘Amendments to IAS 39’) meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that the Amendments to IAS 39:
 - (a) are not contrary to the principle of ‘true and fair view’ set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
 - (b) meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt the Amendments to IAS 39.

Relevance

- 2 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.
- 3 EFRAG considered whether the Amendments to IAS 39 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

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- 4 The nature of novations to central counterparties differs from conventional novations in that both original counterparties remain exposed to the same market risk and that the changes in the terms are limited to those that are necessary to effect the terms of the novated derivative. EFRAG believes that discontinuation of hedge accounting when entities novate hedging instruments to central counterparties would not provide useful information to users of financial statements, especially as those novations reduce counterparty risks and thereby increase overall hedge effectiveness prospectively.
- 5 The Amendments to IAS 39 ensure that many existing hedge relationships can continue to be reported, reflecting the fact that counterparties remain exposed to the same market risk and that the changes in the terms of the derivatives are limited.
- 6 Therefore, EFRAG believes that continuation of hedge accounting, as required under the Amendments to IAS 39, would result in more relevant financial information. However, EFRAG notes that relevance could have been improved further if the scope of the Amendments to IAS 39 had been broader to include all voluntary novations to a central counterparty.
- 7 EFRAG's overall initial assessment is that the Amendments to IAS 39 would result in the provision of relevant information; and therefore they satisfy the relevance criterion.

Reliability

- 8 EFRAG also considered the reliability of the information that will be provided by applying the Amendments to IAS 39. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.
- 9 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.
- 10 EFRAG believes that the Amendments to IAS 39 do not affect the way hedge effectiveness is measured and therefore do not raise any new issues regarding the reliability of hedge accounting.
- 11 EFRAG's overall initial assessment is that the Amendments to IAS 39 would raise no concerns about risk of error or bias; and therefore they satisfy the reliability criterion.

Comparability

- 12 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.
- 13 EFRAG has considered whether the Amendments to IAS 39 result(s) in transactions that are:
 - (a) economically similar being accounted for differently; or
 - (b) transactions that are economically different being accounted for as if they are similar.

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- 14 As noted in paragraph 4 above, the nature of novations to central counterparties differs from conventional novations in that both original counterparties remain exposed to the same market risk and that the changes in the terms are limited to those that are necessary to effect the terms of the novated derivative. In other words, the novation to a central counterparty is economically similar to an ongoing relationship.
- 15 EFRAG notes that some voluntary novations may take place that are not directly or even indirectly linked to consequences of laws or regulations or the introduction of laws or regulations. Those voluntary novations are outside the scope of the Amendments to IAS 39, despite the fact that they are economically similar to those novations that are within the scope of the Amendments to IAS 39. EFRAG believes that this adversely affects comparability.
- 16 However, EFRAG notes that currently diversity in practice exists regarding the interpretation of the derecognition requirements as applied to novations, as some constituents have historically considered that certain novations (e.g. novations to a different legal entity within the same group) do not lead to derecognition. The Amendments to IAS 39 provide clarifications that will reduce diversity in practice and thereby improve comparability.
- 17 On balance, EFRAG's initial assessment is that the Amendments to IAS 39 do not reduce comparability.

Understandability

- 18 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.
- 19 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.
- 20 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments to IAS 39 is understandable, is whether that information will be unduly complex.
- 21 The Amendments to IAS 39 require entities to assess whether or not novations are consequences of laws or regulations or the introduction of laws or regulations. This introduces a certain degree of complexity for preparers who need to make the assessment and for users who need to understand the basis on which the assessment was made.
- 22 However, as noted in paragraph 6 above, EFRAG believes that continuation of hedge accounting, as required under the Amendments to IAS 39, would result in more relevant financial information thereby also improving understandability.
- 23 On balance, EFRAG's initial assessment is that the Amendments to IAS 39 satisfy the understandability criterion.

True and Fair

- 24 EFRAG's initial assessment is that the information resulting from the application of the Amendments to IAS 39 would not be contrary to the true and fair view principle.

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European public good

- 25 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt Amendments to IAS 39.

Conclusion

- 26 For the reasons set out above, EFRAG's initial assessment is that the Amendments to IAS 39 satisfy the technical criteria for EU endorsement and EFRAG should therefore recommend their endorsement.

APPENDIX 3

EFRAG’S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENT

- 1 EFRAG has also considered whether, and if so to what extent, implementing the Amendments to IAS 39 in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from their adoption.

Costs and benefits for preparers

- 2 EFRAG has carried out an initial assessment of the costs and benefits implications for preparers resulting from the Amendments to IAS 39 considering the following costs.
- 3 EFRAG believes that the Amendments will result in some cost savings as preparers will not have to derecognise existing hedge relationships and document new ones.
- 4 Overall, EFRAG’s initial assessment is that the Amendments to IAS 39 are likely to reduce the one-off and costs for preparers and not result in ongoing costs of tracking and analysing information about novation of derivatives and their effects on the continuation of hedge accounting.

Costs and benefits for users

- 5 EFRAG has carried out an initial assessment of the costs and benefits implications for users resulting from the Amendments to IAS 39.
- 6 EFRAG believes that the Amendments to IAS 39 would result in insignificant additional costs of analysis for users, and improve the relevance and understandability of information provided to them. Users will also benefit from having a consistent accounting treatment for derivatives novated to a central counterparty following the introduction of a new law or regulation.
- 7 Overall, EFRAG’s initial assessment is that users are likely to benefit from the Amendments to IAS 39.

Conclusion

- 8 EFRAG’s overall initial assessment is that the overall benefits of the Amendments to IAS 39 are likely to outweigh costs associated with providing this information to users.