

Jonathan Faull
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

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Dear Mr Faull

Adoption of Amendments to IAS 39 Novation of Derivatives and Continuation of Hedge Accounting

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the Amendments to IAS 39 *Novation of Derivatives and Continuation of Hedge Accounting* ('the Amendments to IAS 39'), which were issued by the IASB on 27 June 2013. It was issued as an Exposure Draft in February 2013 and EFRAG commented on that draft.

The objective of the Amendments to IAS 39 is to provide relief from discontinuing hedge accounting when – as a consequence of laws or regulations or the introduction of laws or regulations – hedging instruments are novated to a central counterparty and other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty.

The Amendments to IAS 39 become effective for annual periods beginning on or after 1 January 2014. Earlier application is permitted, however entities shall disclose that fact.

EFRAG has carried out an evaluation of the Amendments to IAS 39. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendments to IAS 39 and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that they:

- 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
- 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.

For the reasons given above, 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 and, accordingly, EFRAG recommends their adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

Amendments to IAS 39 Novation of Derivatives and Continuation of Hedge Accounting

On behalf of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,



Françoise Flores
EFRAG Chairman

APPENDIX BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments to IAS 39 Novation of Derivatives and Continuation of Hedge Accounting ('the Amendments').

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.
- 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 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 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 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.
- 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 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 assessment is that the Amendments to IAS 39 satisfy the understandability criterion.

True and Fair

- 24 EFRAG's 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.

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 the Amendments to IAS 39.

Conclusion

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