

NOVATION OF DERIVATIVES AND CONTINUATION OF HEDGE ACCOUNTING INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/08



Background

As part of actions taken following the global financial crisis, the G20 made a commitment to improve transparency and regulatory oversight of OTC derivatives. It was agreed that all standard over-the-counter (OTC) derivative contracts should be cleared through a central counterparty. A regulation was implemented in Europe which requires certain OTC derivatives to be cleared centrally through an independent counterparty.

As a result, a question was put to the IFRS Interpretations Committee (IFRS IC) as to whether the novation of these OTC derivatives to a central counterparty would result in a requirement to discontinue hedge accounting. This was on the basis that there is a change in the counterparty of the original hedge relationship, meaning that the novation results in a termination of the original derivative contract and the creation of a new derivative contract.

The IFRS IC agreed that the change in counterparty gives rise to a termination of the old, and the creation of a new, derivative contract. The IFRS IC recommended that the International Accounting Standards Board (IASB) should undertake a short term project for a limited scope amendment to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*, providing relief that would allow hedge accounting to continue in this specific circumstance. This was on the basis that a continuation of the hedging relationship would provide more useful information to users of financial statements than the accounting that would result from a discontinuation of the old hedging relationship and (a possible) designation of a new hedging relationship.

At its January 2013 meeting, the IASB agreed that an amendment would be needed to continue the original hedging relationship in these circumstances, and that an amendment would be appropriate. The IASB noted that this issue is not limited to Europe because many jurisdictions have introduced or are expected to mandate, laws or regulations that require the novation of OTC derivatives to a central counterparty.

STATUS

Exposure Draft

EFFECTIVE DATE

To be confirmed

ACCOUNTING IMPACT

Significant for entities that have designated over-the-counter (OTC) derivatives as hedging instruments where those derivatives are required to be novated to a central clearing counterparty by law.

Summary

On 28 February 2013, the IASB published Exposure Draft *ED/2013/2 Novation of Derivatives and Continuation of Hedge Accounting*. The ED proposes to introduce an exception to the discontinuation of hedge accounting in IAS 39 and IFRS 9, under which the novation of a hedging instrument would not trigger discontinuation of hedge accounting if certain strict criteria are met.


The proposed change would introduce a narrow scope exception to the requirement for the discontinuation of hedge accounting in IAS 39 and IFRS 9. This would have a significant effect on entities that have designated OTC derivatives as hedging instruments where those derivatives are now required to be novated to a central clearing counterparty by law.

The exception would apply if the following criteria are met:

- The novation is required by laws or regulations
- The novation results in a central counterparty becoming the new counterparty to each of the parties to the novated derivative, and
- The related changes to the terms of the novated derivative are limited to those necessary to effect the terms of the novated derivative.

The effective date for the amendments, if finalised, is to be confirmed. The ED did not propose any specific transitional provisions. Therefore, retrospective application would apply as required by paragraph 19(a) of IAS 8 *Accounting Policies and Changes in Accounting Estimates and Errors*.

Because these new laws or regulations could come into effect in some jurisdictions very soon, the IASB has published this Exposure Draft with a short (30-day) consultation period, with comments due by 2 April 2013.



This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact your respective BDO member firm to discuss these matters in the context of your particular circumstances. Neither BDO IFR Advisory Limited, Brussels Worldwide Services BVBA, BDO International Limited and/or BDO member firms, nor their respective partners, employees and/or agents accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

Service provision within the international BDO network of independent member firms ('the BDO network') in connection with IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board, is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels.

Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and/or the member firms of the BDO network.

BDO is the brand name for the BDO network and for each of the BDO member firms.

© 2013 BDO IFR Advisory Limited, a UK registered company limited by guarantee. All rights reserved.

www.bdointernational.com

