



MEMBERS' HANDBOOK

Update No. 131

(Issued 16 July 2013)

This Update relates to the issuance of:

- *Novation of Derivatives and Continuation of Hedge Accounting* (Amendments to HKAS 39 *Financial Instruments: Recognition and Measurement*)

<u>Document Reference and Title</u>	<u>Instructions</u>	<u>Explanations</u>
<u>VOLUME II</u>		
Contents of Volume II	Discard existing pages i - ii and replace with revised pages i - ii	Revised contents pages
HONG KONG ACCOUNTING STANDARDS (HKAS)		
HKAS 39 <u><i>Financial Instruments: Recognition and Measurement</i></u>	Replace the cover page, pages 5 and 97-99 with revised cover page, pages 5 and 97-99. Discard pages 100-110	- Note 1-3
HKAS 39 <u><i>Financial Instruments: Recognition and Measurement</i></u> (Basis for Conclusions)	Replace the cover page and pages 4 and 83-84 with revised cover and pages 4.and 83-84. Insert pages 84A-84B after page 84	- Note 1-3

Notes:

1. The narrow-scope amendments will allow hedge accounting to continue in a situation where a derivative, which has been designated as a hedging instrument, is novated to effect clearing with a central counterparty as a result of laws or regulation, if specific conditions are met (in this context, a novation indicates that parties to a contract agree to replace their original counterparty with a new one).
2. This relief has been introduced in response to legislative changes across many jurisdictions that would lead to the widespread novation of over-the-counter derivatives. These legislative changes were prompted by a G20 commitment to improve transparency and regulatory oversight of over-the-counter derivatives in an internationally consistent and non-discriminatory way.
3. Similar relief will be included in HKFRS 9 *Financial Instruments*.



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(Updated to July 2013)

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Hong Kong Accounting Standard 39

Financial Instruments: Recognition and Measurement



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Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) is set out in paragraphs 1-109 and Appendices A-C. All the paragraphs have equal authority. HKAS 39 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Appendix C

Amendments resulting from other HKFRSs to HKAS 39 – Novation of Derivatives and Continuation of Hedge Accounting

The following sets out amendments required for this Standard resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

Paragraphs 91 and 101 are amended. New text is underlined and deleted text is struck through.

Fair value hedges

...

91 An entity shall discontinue prospectively the hedge accounting specified in paragraph 89 if:

(a) the hedging instrument expires or is sold, terminated or exercised, ~~(For this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy).~~ Additionally, for this purpose there is not an expiration or termination of the hedging instrument if:

(i) 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.

(ii) 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 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.

(b) ...

...

Cash flow hedges

...

101 In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95–100:

(a) ~~The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy).~~ In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies. For the purpose of this subparagraph, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy. Additionally, for the purpose of this subparagraph there is not an expiration or termination of the hedging instrument if:

(i) 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.

(ii) 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 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.

(b) ...

Paragraph 108D and, in Appendix A, paragraph AG113A are added.

Effective date and transition

...

108D *Novation of Derivatives and Continuation of Hedge Accounting* (Amendments to HKAS 39), issued in July 2013, amended paragraphs 91 and 101 and added paragraph AG113A. An entity shall apply those paragraphs for annual periods beginning on or after 1 January 2014. An entity shall apply those amendments retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact.

...

Assessing hedge effectiveness

...

AG113A For the avoidance of doubt, the effects of replacing the original counterparty with a clearing counterparty and making the associated changes as described in paragraphs 91(a)(ii) and 101(a)(ii) shall be reflected in the measurement of the hedging instrument and therefore in the assessment of hedge effectiveness and the measurement of hedge effectiveness.

Basis for Conclusions
Hong Kong Accounting Standard 39

Financial Instruments: Recognition and Measurement



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Appendix

Amendments ~~resulting from other~~to the Basis for Conclusions on IAS 39 – Novation of Derivatives and Continuation of Hedge Accounting

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued IFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

A heading and paragraphs BC220A–BC220W are added. Footnotes must be renumbered accordingly.

Novation of derivatives and continuation of hedge accounting

BC220A The IASB received an urgent request to clarify whether an entity is required to discontinue hedge accounting for hedging relationships in which a derivative has been designated as a hedging instrument in accordance with IAS 39 when that derivative is novated to a central counterparty (CCP) due to the introduction of a new law or regulation.¹

BC220B The IASB considered the derecognition requirements of IAS 39 to determine whether the novation in such a circumstance leads to the derecognition of an existing derivative that has been designated as a hedging instrument. The IASB noted that a derivative should be derecognised only when it meets both the derecognition criteria for a financial asset and the derecognition criteria for a financial liability in circumstances in which the derivative involves two-way payments between parties (ie the payments are or could be from and to each of the parties).

BC220C The IASB observed that paragraph 17(a) of IAS 39 requires that a financial asset is derecognised when the contractual rights to the cash flows from the financial asset expire. The IASB noted that through novation to a CCP, a party (Party A) to the original derivative has new contractual rights to cash flows from a (new) derivative with the CCP, and this new contract replaces the original contract with a counterparty (Party B). Thus the original derivative with Party B has expired and as a consequence the original derivative through which Party A has engaged with Party B shall meet the derecognition criteria for a financial asset.

BC220D The IASB also observed that paragraph AG57(b) of IAS 39 states that a financial liability is extinguished when the debtor is legally released from primary responsibility for the liability. The IASB noted that the novation to the CCP would release Party A from the responsibility to make payments to Party B and also would oblige Party A to make payments to the CCP. Consequently, the original derivative through which Party A has transacted with Party B also meets the derecognition criteria for a financial liability.

¹ In this context, the term 'novation' indicates that the parties to a derivative 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 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.

- BC220E** Consequently, the IASB concluded that the novation of a derivative to a CCP would be accounted for as the derecognition of the original derivative and the recognition of the (new) novated derivative.
- BC220F** Taking into account the conclusion of the assessment on the derecognition requirements, the IASB considered paragraphs 91(a) and 101(a) of IAS 39, which require an entity to discontinue hedge accounting prospectively if the hedging instrument expires or is sold, terminated or exercised. The IASB noted that novation to a CCP would require the entity to discontinue hedge accounting because the derivative that was designated as a hedging instrument has been derecognised and consequently the hedging instrument in the existing hedging relationship no longer exists.
- BC220G** The IASB, however, was concerned about the financial reporting effects that would arise from novations that result from new laws or regulations. The IASB noted that the requirement to discontinue hedge accounting meant that although an entity could designate the new derivative as the hedging instrument in a new hedging relationship, this could result in more hedge ineffectiveness, especially for cash flow hedges, compared to a continuing hedging relationship. This is because the derivative that would be newly designated as the hedging instrument would be on terms that would be different from a new derivative, ie it was unlikely to be 'at-market' (for example, a non-option derivative such as a swap or forward might have a significant fair value) at the time of the novation. The IASB also noted that there would be an increased risk that the hedging relationship would fail to fall within the 80–125 per cent hedge effectiveness range required by IAS 39.
- BC220H** The IASB, taking note of these 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 IASB also considered the feedback from outreach that involved the members of the International Forum of Accounting Standard Setters (IFASS) and securities regulators and noted that this issue is not limited to a specific jurisdiction because many jurisdictions have introduced, or are expected to mandate, laws or regulations that encourage or require the novation of derivatives to a CCP.
- BC220I** The IASB noted that 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. Specifically, the G20 agreed to improve OTC derivatives markets so that all standardised OTC derivatives contracts are cleared through a CCP.
- BC220J** The IASB also considered the draft requirements of the forthcoming hedge accounting chapter of IFRS 9. The IASB noted that those draft requirements also would require hedge accounting to be discontinued if the novation to a CCP occurs.
- BC220K** Consequently, the IASB decided to publish, in January 2013, the Exposure Draft *Novation of Derivatives and Continuation of Hedge Accounting* ('ED/2013/2'), which proposed amendments to IAS 39 and IFRS 9. In ED/2013/2, the IASB proposed to amend paragraphs 91(a) and 101(a) of IAS 39 to provide relief from discontinuing hedge accounting when the novation to a CCP is required by new laws or regulations and meets certain criteria. The IASB decided to set the comment period for those proposals to 30 days. The IASB noted that the reduced comment period was necessary because the amendments should be completed urgently because the new laws or regulations to effect CCP clearing of OTC derivatives would come into force within a short period; the contents of the proposed amendments were short; and there was likely to be a broad consensus on the topic.

BC220L When developing ED/2013/2, the IASB tentatively decided that the terms of the novated derivative should be unchanged other than the change in counterparty, however, the IASB noted that, in practice, other changes may arise as a direct consequence of the novation. For example, in order to enter into a derivative with a CCP it may be necessary to make adjustments to the collateral arrangements. Such narrow changes that are a direct consequence of or are incidental to the novation were acknowledged in the proposed amendments. However, this would not include changes to, for example, the maturity of the derivatives, the payment dates, or the contractual cash flows or the basis of their calculation, except for charges that may arise as a consequence of transacting with a CCP.

BC220M When developing ED/2013/2, the IASB also discussed whether to require an entity to disclose that it has been able to continue hedge accounting by applying the relief provided by these proposed amendments to IAS 39 and IFRS 9. The IASB tentatively decided that it was not appropriate to mandate specific disclosure in this situation because, from the perspective of a user of financial statements, the hedge accounting would be continuing.

BC220N A total of 78 respondents commented on ED/2013/2. The vast majority of respondents agreed that the proposed amendments are necessary. However, a few respondents expressed disagreement with the proposal on the basis that they disagreed with the IASB's conclusion that hedge accounting would be required to be discontinued as a result of such novations. In expressing such disagreement some noted that IAS 39 expressly acknowledges that certain replacements or rollovers of hedging instruments are not expirations or terminations for the purposes of discontinuing hedge accounting. The IASB noted that this exception applies if '[a] replacement or rollover is part of the entity's documented hedging strategy'(IAS 39.91(a) and IAS 39.101(a)). The IASB questioned whether replacement of a contract as a result of unforeseen legislative changes (even if documented) fits the definition of a replacement that is part of a 'documented hedging strategy'.

BC220O Even though the vast majority of respondents agreed with the proposal, a considerable majority of respondents disagreed with the scope of the proposed amendments. They believed that the proposed scope of 'novation required by laws or regulations' is too restrictive and that the scope therefore should be expanded by removing this criterion. In particular, they argued that voluntary novation to a CCP should be provided with the same relief as novation required by laws or regulations. A few respondents further requested that the scope should not be limited to novation to a central counterparty and that novation in other circumstances should also be considered.

BC220P In considering respondents' comments, the IASB noted that voluntary novation to a CCP could be prevalent in some circumstances such as novation in anticipation of regulatory changes, novation due to operational ease, and novation induced but not actually mandated by laws or regulations as a result of the imposition of charges or penalties. The IASB also noted that many jurisdictions would not require the existing stock of outstanding historical derivatives to be moved to CCPs, although this was encouraged by the G20 commitment.

BC220Q The IASB observed, however, that for hedge accounting to continue voluntary novation to a CCP should be associated with laws or regulations that are relevant to central clearing of derivatives. The IASB noted that while a novation need not be required by laws or regulations for hedge accounting to be allowed to continue, allowing all novations to CCPs to be accommodated was broader than the IASB had intended. In addition, the IASB agreed that hedge accounting should continue when novations are performed as a consequence of laws or regulations or the introduction of laws of regulations but noted that the mere possibility of laws or regulations being introduced was not a sufficient basis for the continuation of hedge accounting.

BC220R Some respondents were concerned that restricting the relief to novation directly to a CCP was too narrow. In considering respondents' comments, the IASB noted that in some cases a CCP has a contractual relationship only with its 'clearing members', and therefore an entity must have a contractual relationship with a clearing member in order to transact with a CCP; a clearing member of a CCP provides a clearing service to its client who cannot access a CCP directly. The IASB also noted that some jurisdictions are introducing a so-called 'indirect clearing' arrangement in their laws or regulations to effect clearing with a CCP, by which a client of a clearing member of a CCP provides a (indirect) clearing service to its client in the same way as a clearing member of a CCP provides a clearing service to its client. In addition, the IASB observed that an intragroup novation also can occur in order to access a CCP; for example, if only particular group entities can transact directly with a CCP.

BC220S On the basis of respondents' comments, the IASB decided to expand the scope of the amendments by providing relief for novations to entities other than a CCP if such novation is undertaken with the objective of effecting clearing with a CCP rather than limiting relief to situations in which novation is directly to a CCP. The IASB decided that in these circumstances the novation had occurred in order to effect clearing through a CCP, albeit indirectly. The IASB thus decided also to include such novations in the scope of the amendments because they are consistent with the objective of the proposed amendments—they enable hedge accounting to continue when novations occur as a consequence of laws or regulations or the introduction of laws or regulations that increase the use of CCPs. However, the IASB noted that when parties to a hedging instrument enter into novations with different counterparties (for example, with different clearing members), these amendments only apply if each of those parties ultimately effects clearing with the same central counterparty.

BC220T Respondents raised a concern about the phrase 'if and only if' that was used in ED/2013/2 when describing that the relief is provided 'if and only if' the criteria are met. In considering respondents' comments, the IASB noted that ED/2013/2 was intended to address a narrow issue—novation to CCPs—and therefore changing the phrase 'if and only if' to 'if' would target the amendment on the fact patterns that the IASB sought to address. The IASB noted that this would have the effect of requiring an analysis of whether the general conditions for continuation of hedge accounting are satisfied in other cases (for example, as was raised by some respondents, in determining the effect of intragroup novations in consolidated financial statements).

BC220U The IASB decided to make equivalent amendments to the forthcoming chapter on hedge accounting that will be incorporated into IFRS 9, as proposed in ED/2013/2; no respondents opposed this proposal.

BC220V ED/2013/2 did not propose any additional disclosures. The vast majority of respondents agreed with this. The IASB confirmed that additional disclosures are not required. However, the IASB noted that an entity may consider disclosures in accordance with IFRS 7 *Financial Instruments: Disclosures*, which requires qualitative and quantitative disclosures about credit risk.

BC220W The IASB also decided to retain in the final amendments the transition requirements proposed in ED/2013/2 so that the amendments should apply retrospectively and early application should be permitted. The IASB noted that even with retrospective application, if an entity had previously discontinued hedge accounting, as a result of a novation, that (pre-novation) hedge accounting relationship could not be reinstated because doing so would be inconsistent with the requirements for hedge accounting (ie hedge accounting cannot be applied retrospectively).