FASB Clarifies Hedge Accounting May Continue After Derivative Novation

On March 10, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-05, *Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships.* The ASU clarifies that a change in one of the counterparties to a derivative contract, *i.e.*, a novation, does not—in and of itself—require dedesignation of that hedge accounting relationship. FASB concluded that hedge accounting relationships could continue as long as all other hedge accounting criteria continue to be met. A change in the counterparty's creditworthiness must be considered in determining whether the hedging relationship continues to qualify for hedge accounting as well as the amount of hedge ineffectiveness to be recorded, to the extent it does qualify for hedge accounting. By clarifying the accounting impact of a derivative contract novation, the ASU will reduce diversity in practice and eliminate the recording of hedging ineffectiveness for most novations.

Background

The term "novation" refers to replacing one party to the derivative contract with another; it allows a new counterparty to assume the original counterparty's rights and obligations. Reasons for novations include (but are not limited to) regulatory changes such as a change to a central clearing arrangement, mergers of financial institutions, an entity exiting a particular derivatives line of business or relationship or an entity managing against internal counterparty credit limits.

Existing guidance on the effect of a change in counterparty to a derivative instrument is not clear and has been interpreted and applied inconsistently in practice. Topic 815 requires discontinuance of hedge accounting if the derivative is "terminated" or the "critical" terms of the hedging relationship change. Diversity in practice has arisen since the critical terms are not explicitly defined in Topic 815 and industry participants have different views on whether a novated contract is a continuation of an existing contract or a new contract. In addition, public entities refer to two pieces of guidance issued by the Securities and Exchange Commission (SEC) that list situations where it would not object to the continuation of hedge accounting after a novation.

The ASU clarifies that a change in the counterparty to a derivative instrument would not—in and of itself—be considered a "termination" of the original derivative instrument, as the hedging relationship is largely unaffected by the change. The ASU also clarifies that a change in the counterparty to a derivative instrument would not—in and of itself—be considered a change in a critical term of the hedging relationship, since it does not affect the amount and timing of contractual cash flows.

Transition

In a change from the exposure draft, the ASU can be adopted on either a prospective or a modified retrospective basis. Entities electing prospective adoption would apply the ASU to all existing and new hedge accounting relationships in which a change in derivative counterparty occurs after adoption date.

Entities electing the modified retrospective approach are not allowed to cherry-pick favorable hedging relationships. The ASU must be applied to all derivative instruments that meet these conditions:

- The derivative was outstanding during all or a portion of the periods presented in the financial statements. (Restatement is not permitted for a derivative not outstanding at the beginning of the earliest period presented in the financial statements.)
- The derivative was previously designated as a hedging instrument in a hedging relationship.

- The hedging relationship was dedesignated solely due to a novation of the derivative, and all other hedge accounting criteria would have otherwise continued to be met.

Under this approach, derivative instruments that were dedesignated from hedging relationships during a period presented in the financial statements should have the effect of the dedesignation removed from the financial statements for each period presented.

An entity would restate each period presented to remove the effect of dedesignation if a derivative was dedesignated before the beginning of the earliest period presented but remained outstanding during any periods presented. Beginning retained earnings would be adjusted to reflect the cumulative effect to financial statements before the beginning of the earliest period presented.

The effectiveness assessment and ineffectiveness measurement required under the original hedge should be performed for all periods between the dedesignation date (only if solely due to novation) and the ASU's adoption date.

Effective Date

For public business entities, the ASU is effective for annual periods beginning after December 15, 2016, and interim periods therein. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods beginning after December 15, 2018. Early adoption is permitted for all entities upon issuance, including adoption in an interim period.

For more information, contact your BKD advisor.