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To the Point

FASB — final guidance

FASB says hedge accounting relationships may continue after a novation

A novation, in and of itself, is not deemed a termination of a derivative or a change in the critical terms of a hedging relationship.

What you need to know

- The FASB issued final guidance clarifying that the novation of a derivative contract in a hedge accounting relationship does not, in and of itself, require dedesignation of that hedge accounting relationship.
- Hedge accounting relationships could continue as long as all of the other hedge accounting criteria are met, including the expectation that the hedge will be highly effective when the creditworthiness of the new counterparty to the derivative contract is considered.
- For public business entities, the guidance is effective for fiscal years beginning after 15 December 2016, and interim periods within those years. For all other entities, it is effective for fiscal years beginning after 15 December 2017, and interim periods within fiscal years beginning after 15 December 2018. Early adoption is permitted.
- Entities may adopt the guidance prospectively or use a modified retrospective approach to apply it to derivatives outstanding during all or a portion of the periods presented in the period of adoption.

Overview

The Financial Accounting Standards Board (FASB) issued final guidance[1] clarifying that the novation of a derivative contract (i.e., a change in the counterparty) in a hedge accounting relationship does not, in and of itself, require dedesignation of that hedge accounting relationship. The guidance amends Accounting Standards Codification (ASC) 815[2] to clarify that such a change does not, in and of itself, represent a termination of the original derivative instrument or a change in the critical terms of the hedge relationship.

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As a result, the hedging relationship could continue uninterrupted if all of the other hedge accounting criteria are met, including the expectation that the hedge will be highly effective when the creditworthiness of the new counterparty to the derivative contract is considered. The new guidance was developed by the Emerging Issues Task Force (EITF).

Background

Novations occur for various reasons, including financial institution mergers, intercompany transactions, a counterparty's decision to exit a derivatives business, an entity's desire to reduce the credit exposure to a particular counterparty or regulatory requirements (e.g., the requirement under the Dodd–Frank Wall Street Reform and Consumer Protection Act that many over-the-counter derivatives be centrally cleared).

When it added this issue to the EITF agenda, the FASB noted that US GAAP was "not explicitly clear" about how a change in the counterparty to a derivative contract affects hedge accounting. While ASC 815 requires an entity to discontinue hedge accounting if the designated derivative instrument is terminated[3] or the critical terms of the hedging relationship change,[4] there have historically been different views about whether a novation should be considered a termination of a derivative contract under ASC 815 or whether it would represent a change in the critical terms of the hedging relationship. The Securities and Exchange Commission staff recently noted that it understood a novation to generally be a legal termination that would result in dedesignation, but the staff stated it would not object to an entity continuing to apply hedge accounting after a novation in certain situations.[5]

Key considerations

In reaching its conclusion, the EITF noted that the analysis of whether a derivative instrument has been "terminated" in the context of hedge accounting was intended to go beyond a legal determination to focus on whether the hedging relationship itself would continue to exist. When the only change to a derivative contract designated in a hedging relationship is the counterparty, and there are no concerns about the collectibility of the derivative's cash flows or effectiveness of the hedge relationship, the EITF observed that the hedging relationship is largely unaffected, and a "termination" of the derivative instrument (as that term is used in ASC 815) should not be deemed to have occurred.

The EITF also noted that ASC 815 does not refer to the counterparty in a derivative contract as a "critical term." Instead, it refers to terms that affect the amount and timing of contractual cash flows as critical terms. Changes in terms that do not affect the contractual cash flows in a derivative contract but may affect the probability of performance of these contractual terms are required to be evaluated under the counterparty default guidance in ASC 815.[6] As such, a change in counterparty would only result in the dedesignation of a hedge relationship if the hedge is no longer expected to be highly effective due to the creditworthiness of the new counterparty. The EITF noted that the evaluation of counterparty default risk applies to all hedging relationships, regardless of whether there has been a change in counterparty.

How we see it

The guidance provides a principle that can be applied consistently to all novations. It will improve financial reporting because novations will no longer cause effective hedges to be dedesignated and then redesignated, which could require an entity to record ineffectiveness that did not exist in the original hedge. That's because the novated derivative would likely not have a fair value of zero when the hedge is redesignated.

The EITF also observed that novations generally require the consent of the other party to the derivative, and that party is unlikely to agree to a novation to a counterparty that is significantly less creditworthy without receiving consideration. The final guidance does not address situations in which cash or other consideration is exchanged as a result of a novation. In these cases, a dedesignation of the original hedging relationship may be required.

Disclosures, transition and effective date

The guidance is effective for public business entities for annual periods beginning after 15 December 2016, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2017, and interim periods within annual periods beginning after 15 December 2018. Early adoption is permitted, including adoption in an interim period.

Entities are not required to make any additional disclosures beyond disclosures about a change in accounting principle in the period of adoption.[7]

Entities will no longer have to dedesignate an effective hedge and potentially record ineffectiveness upon redesignation.

Entities may apply the guidance prospectively or on a modified retrospective basis. Entities adopting the guidance prospectively will apply it to all existing hedging relationships in which a change in the counterparty to a derivative instrument occurs after adoption. Those electing the modified retrospective approach will apply it to all derivatives that were outstanding during all or a portion of the periods presented in the financial statements in the period of adoption and had previously been designated as the hedging instruments in hedging relationships that were dedesignated due to a novation. An entity may not use this approach to revise its financial statements for derivative instruments that were no longer outstanding as of the beginning of the earliest period presented in the financial statements.

Under the modified retrospective approach, assessment of effectiveness and measurement of ineffectiveness as required by the original hedge documentation would be performed for all periods between the date of dedesignation due solely to a novation and the date of adoption. If the hedge remained highly effective during this period, the financial statements would be presented as if dedesignation of the hedge relationship had not occurred. That is, the effect of the dedesignation would be removed for each period presented.

In addition, if the novation and dedesignation occurred before the earliest period presented and the derivative remained outstanding during all or a portion of the periods presented, the elimination of the effect of the dedesignation for any periods before the beginning of the earliest year presented would be reflected as a cumulative-effect adjustment to beginning retained earnings. The appendix to this publication contains an example of transition under the modified retrospective approach.

How we see it

While all entities can use the modified retrospective approach, it may be most helpful for those that used the shortcut method to account for a particular hedge relationship but after a redesignation due to a novation were required to use the long-haul method. The modified retrospective transition approach could eliminate the cost and complexity of applying the long-haul method for these hedge relationships.

Endnotes:

[1] Accounting Standards Update No. 2016-05, *Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships.*

[2] ASC 815, *Derivatives and Hedging.*

[3] ASC 815-25-40-1 and ASC 815-30-40-1.

[4] ASC 815-20-55-56.

[5] See remarks by Hillary H. Salo at the 2014 AICPA National Conference on Current SEC and PCAOB Developments. http://www.sec.gov/News/Speech/Detail/Speech/1370543610129.

[6] ASC 815-20-35-14 through 35-18.

[7] Entities should provide the disclosures in paragraphs ASC 250-10-50-1(a) and 50-2 in the period of adoption. Entities that elect to apply the guidance using the modified retrospective approach should also provide disclosures in paragraph 250-10-50-1(b)(1) and (b)(3).

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Appendix: Example of modified retrospective application

This example illustrates the application of the modified retrospective transition approach to a hedge relationship that was dedesignated before the earliest comparative period presented in the financial statements in the period of adoption. The entity can apply the modified retrospective approach because the derivative instrument remained outstanding as an economic hedge after the hedge relationship was dedesignated. If the entity had terminated the derivative contract before the beginning of the earliest period presented in the financial statements, it wouldn't be able to use the modified retrospective approach.

The functional currency of Entity A is US dollars. Entity A expects to make a payment of 10,000,000 Canadian dollars (CAD) on 31 December 2017. To hedge the effect of currency fluctuations, Entity A entered into a four-year forward contract to purchase CAD10,000,000 for $6,666,666 (a forward rate of $1 to CAD1.5) and designated the forward contract in a cash flow hedge relationship on 1 January 2013. The hedge relationship was perfectly effective for six months, but the counterparty to the forward contract then novated the derivative instrument to another bank. Solely as a result of the novation, Entity A dedesignated the hedge relationship on 1 July 2013. Entity A retained the forward contract as an economic hedge and began recognizing changes in its fair value immediately in the income statement each period.

This table shows the fair value of the forward contract at various dates:

Date	Fair value of derivative
1/1/2013	$ 0
6/30/2013	$ 1,100,000.00
12/31/2013	$ 1,200,000.00
12/31/2014	$ 1,500,000.00
12/31/2015	$ 1,600,000.00
12/31/2016	$ 1,800,000.00

As of 31 December 2016, Entity A early adopts the new guidance and uses the modified retrospective approach because the forward contract meets all of the required criteria. As a result, Entity A records a cumulative-effect adjustment to beginning retained earnings as of 1 January 2014, the earliest comparative period presented. The adjusting entry is a debit to beginning retained earnings and a credit to other comprehensive income (OCI) of $100,000 to reclassify the change in the fair value of the derivative during the period 1 July 2013 to 31 December 2013 to OCI as if the hedge had not been dedesignated.

Entity A also adjusts each of the comparative financial statements to reclassify the change in fair value of the derivative recorded in earnings during each period to OCI. For example, for 2014, Entity A reclassifies $300,000 from earnings to OCI. The result of all the reclassifications is a credit balance in OCI of $1,800,000 at 31 December 2016, which equals the fair value of the derivative and the amount that would have been recorded in OCI if the hedge had not been dedesignated and had remained perfectly effective.