

AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT

FASB



SUBJECT

FASB ISSUES ASU ON THE EFFECT OF DERIVATIVE CONTRACT NOVATIONS ON EXISTING HEDGES

SUMMARY

The FASB recently issued ASU 2016-05¹ to clarify that a change in the counterparty to a derivative instrument that has been designated as a hedging instrument does not, on its own, require dedesignation of that hedge accounting relationship provided that all other hedge accounting criteria continue to be met. The ASU is available [here](#), and becomes effective for public entities in 2017. Early adoption is allowed.

DETAILS

Main Provisions

The term novation, as it relates to derivative instruments, refers to replacing one of the parties to a derivative instrument with a new party, which may occur for a variety of business or regulatory reasons. The derivative instrument that is the subject of a novation may be the hedging instrument in a designated hedging relationship.

ASC 815² requires an entity to discontinue the designated hedging relationship in certain circumstances, including termination of the derivative hedging instrument or if the entity wishes to change any of the critical terms of the hedging relationship. The ASU amends Topic 815 to clarify that novation of a derivative designated as the hedging instrument would not, in and of itself, be considered a termination of the derivative instrument or a change in critical terms requiring discontinuation of the designated hedging relationship.

CONTACT:

GAUTAM GOSWAMI
National Assurance Partner
(312) 616-4631
ggoswami@bdo.com

ANGELA NEWELL
National Assurance Partner
(214) 689-5669
ajnewell@bdo.com

ADAM BROWN
National Director of Accounting
(214) 665-0673
abrown@bdo.com

¹ *Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships*

² *Derivatives and Hedging*

BDO Observation: While clarifying the novation, in and of itself, does not preclude continued use of hedge accounting, the basis for conclusions to the ASU notes that in determining whether the hedging relationship continues to qualify for hedge accounting, the counterparty default guidance in ASC 815 requires entities to always assess the creditworthiness of a derivative counterparty in a hedging relationship—both in the normal course and upon a novation.

Effective Date and Transition

The amendments are effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption is permitted.

The amendments may be applied on either a prospective or a modified retrospective basis. The modified retrospective approach is only available when certain specific conditions are met and is also subject to detailed transition guidance.

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