FASB In Focus

Reference Rate Reform

Background

On September 5, 2019, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update (ASU) to provide temporary optional guidance to ease the potential burden in accounting for (or recognizing the effects of) reference rate reform on financial reporting.

Stakeholders are encouraged to review and provide comments on the proposed ASU by October 7, 2019.

Why Is the FASB Issuing This Proposed ASU?

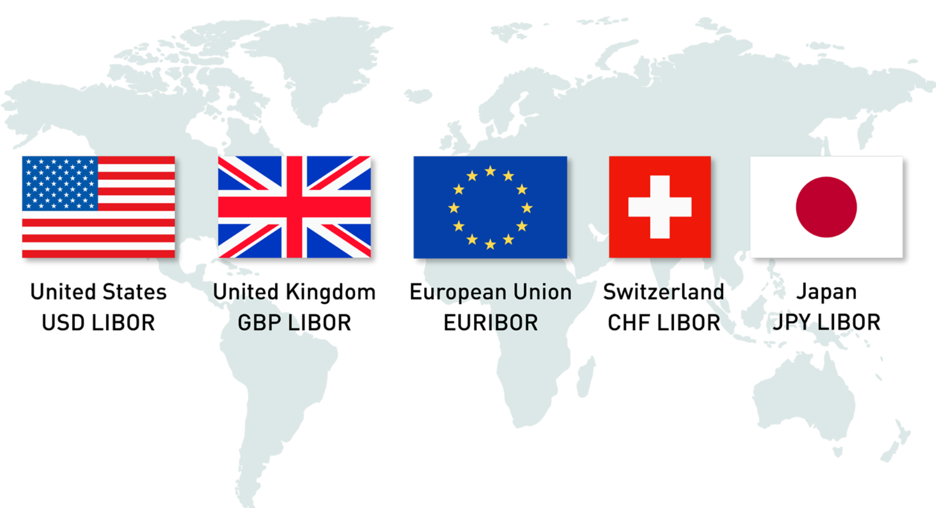
In response to concerns about structural risks of interbank offered rates (IBORs), and, particularly, the risk of cessation of the London Interbank Offer Rate (LIBOR), regulators around the world have undertaken reference rate reform initiatives to identify alternative reference rates that are more observable or transaction based and less susceptible to manipulation.

Stakeholders raised certain operational challenges likely to arise in accounting for contract modifications and hedge accounting due to reference rate reform. Some of those challenges relate to the significant volume of contracts and other arrangements, such as debt agreements, lease agreements, and derivative instruments, which will need to be modified to replace references to discontinued rates with references to replacement rates.

For accounting purposes, such contract modifications are required to be evaluated in determining whether the modifications result in the establishment of new contracts or the continuation of existing contracts. Stakeholders indicated that the application of existing accounting standards on modifications could be costly and burdensome due to the significant volume of affected contracts and the compressed time frame for making contract modifications, and the financial reporting results should reflect the intended continuation of such contracts and arrangements.

Global Perspective

Examples of Reference Rates Undergoing Reform



Stakeholders raised additional accounting issues specific to hedge accounting. Specifically, changes in a reference rate could disallow the application of certain hedge accounting guidance, and certain hedge relationships may not qualify as highly effective during the period of the market-wide transition to a replacement rate.

Stakeholders indicated that the inability to apply hedge accounting because of reference rate reform would result in financial reporting outcomes that would not reflect entities' intended hedging strategies when those strategies continue to operate as effective hedges.

What Are the Main Provisions in the Proposed ASU?

The amendments in the proposed Update would provide temporary optional expedients and exceptions for applying generally accepted accounting principles (GAAP) to contracts, hedging relationships, and other transactions affected by reference rate reform if certain criteria are met.

The amendments in the proposed Update would apply only to contracts and hedging relationships that reference LIBOR or another reference rate expected to be discontinued due to reference rate reform. The proposed expedients and exceptions provided by the amendments would not apply to contract modifications made and hedging relationships entered into or evaluated after December 31, 2022.

The proposed guidance would provide the following optional expedients that reduce costs and complexity of accounting for reference rate reform:

Overview of Proposed Guidance

	Current Accounting	Optional Relief
Contract Modifications	High volume of modifications results in **burdensome** accounting evaluations	**Simplified** accounting evaluations scaled for high volume of modifications
Hedge Accounting	Hedge accounting **discontinued** when contract is modified	Hedge accounting **preserved** when contract is modified
	Hedge accounting **discontinued** if hedging relationship is not highly effective during the temporary transition period	Hedge accounting **preserved** during the temporary transition period, with any hedge breakage/mismatch visible in the financial statements

1. Simplify accounting analyses under current GAAP for contract modifications if qualifying criteria are met:
   a. Modifications of loans, debt, and other financial instruments would be accounted for by prospectively adjusting the effective interest rate.
   b. Lease modifications would be accounted for as a continuation of the existing contract with no reassessments or remeasurements.
   c. Modifications of contracts would not require a reassessment of whether an embedded derivative should be accounted for as a separate instrument.
   d. Modifications of contracts for which explicit guidance is not proposed would also be accounted for as a continuation of those contracts with no reassessments of previous determinations.
2. Allow hedging relationships to continue without dedesignation upon the following changes in the critical terms of an existing hedging relationship due to reference rate reform:
   a. A change in the critical terms of a designated hedging instrument in a fair value, cash flow, or net investment hedge
   b. A change to rebalance or adjust the hedging relationship
   c. For a cash flow hedge, a change in the method used to assess hedge effectiveness when initially applying an optional expedient method and when reverting to the requirements under current GAAP.
3. Provide optional expedients for existing fair value hedging relationships for which the derivative designated as the hedging instrument is affected by reference rate reform:
   a. An entity may change the designated benchmark rate to a different eligible benchmark rate.
   b. An entity that applied the shortcut method of accounting may continue to apply that method for the remainder of the hedging relationship.
4. Provide temporary optional expedients for cash flow hedging relationships affected by reference rate reform:
   a. If the designated hedged risk is a rate that is affected by reference rate reform, an entity would disregard the potential change in the designated hedged risk that may occur due to reference rate reform when the entity assesses whether the hedged forecasted transaction is probable and an entity may continue hedge accounting for an existing cash flow hedge for which the hedged risk changes if either the hedge is highly effective or an optional expedient method is elected.
   b. For existing cash flow hedges for which the shortcut method or another method that assumes perfect hedge effectiveness is applied, entities would be permitted to continue to apply that method.
   c. For new cash flow hedges for which either the hedging instrument or hedged forecasted transactions would reference a rate that is expected to be affected by reference rate reform, entities would be permitted to adjust the application of the methods used to initially assess whether cash flow hedge accounting may be applied to disregard the mismatch in variable

interest rate indexes between the designated hedging instrument and the hedged item.

d. For new cash flow hedges of portfolios of forecasted transactions that reference a rate that is expected to be affected by reference rate reform, an entity may disregard the requirement that the group of individual transactions share the same risk exposure for which they are designated as being hedged.

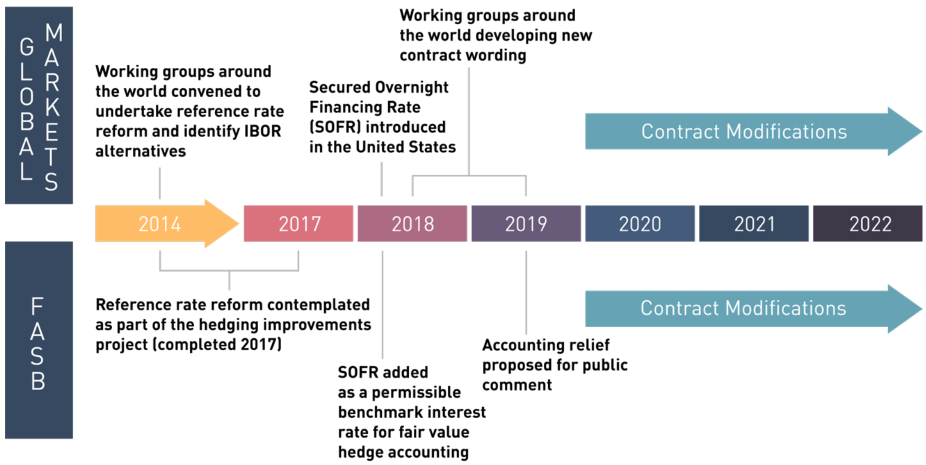
e. For both existing and new cash flow hedges, entities may adjust the application of the methods used to subsequently assess whether cash flow hedge accounting may be applied to disregard the mismatch in variable interest rate indexes between the designated hedging instrument and the hedged item due to reference rate reform. Alternatively, an entity may elect an optional expedient to continue cash flow hedge accounting if certain qualitative criteria are met each period, effectively suspending subsequent cash flow hedge effectiveness assessments.

An entity can elect to apply the proposed amendments as follows:

1. The optional expedients for contract modifications would be applied consistently for all contracts or transactions within the relevant Topic, Subtopic, or Industry Subtopic within the Codification that contains the guidance that otherwise would be required to be applied.

2. The optional expedients for hedging relationships would be elected on an individual hedging relationship basis.

Moving in Tandem with Global Markets



Who Would Be Affected by the Amendments in This Proposed ASU?

The amendments in the proposed Update would be elective and would apply to all entities, subject to meeting certain qualifying criteria, for contract modifications or hedging relationships that are referencing LIBOR or another reference rate expected to be discontinued due to reference rate reform.

When Would the Proposed Guidance Become Effective?

The proposed amendments would be effective for all entities upon the issuance of a final Update. Upon adoption, an entity may elect to apply the proposed amendments prospectively to contract modifications made and to hedging relationships existing as of or entered into on or after the date of adoption and through December 31, 2022. The proposed amendments would not apply to contract modifications made and hedging relationships entered into or evaluated after December 31, 2022.

For more information about the project, please visit the FASB's website at www.fasb.org.

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