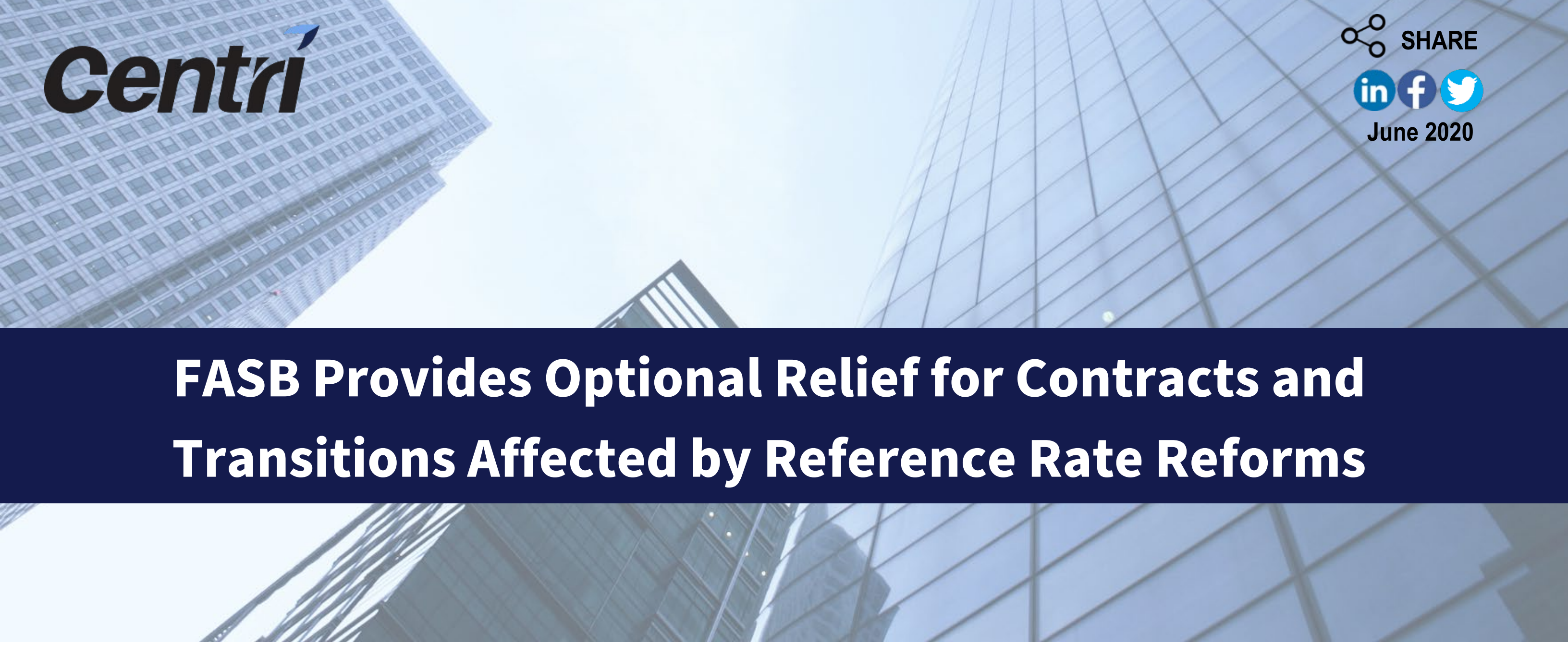

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FASB Provides Optional Relief for Contracts and Transitions Affected by Reference Rate Reforms

Summary

The FASB issued ASU 2020-04, Reference Rate Reform (ASC 848*): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*, ("ASU") to provide optional expedients and exceptions for applying U.S. GAAP to contract modifications, hedging relationships, and other transactions affected by the anticipated transition away from LIBOR. The new ASU is available here, is eligible to be applied upon issuance, and has various transition requirements.

Background

Reference rates such as the London Interbank Offered Rate (LIBOR) are widely used in a broad range of financial instruments and other agreements. In response to concerns about structural risks of interbank offered rates (IBORs), regulators in several jurisdictions around the world have undertaken efforts, generally referred to as reference rate reform, to identify alternative reference rates that are more observable or transaction-based and less susceptible to manipulation. As a result of the reference rate reform initiative, certain widely used reference rates such as LIBOR are expected to be discontinued ("affected rates").

The ASU adds Topic 848, Reference Rate Reform, which provides optional guidance for a limited period of time to ease the potential burden in accounting for the effects of reference rate reform on financial reporting.

Scope

The optional expedients and exceptions for applying generally accepted accounting principles (GAAP) in the ASU apply only to contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued as a result of reference rate reform.

Main Provisions

Contract modifications

The FASB was made aware of certain operational challenges likely to arise in accounting for contract modifications due to reference rate reform. Specifically, entities will have to assess a significant volume of contracts and other arrangements, such as debt agreements, lease agreements, and derivative instruments, in determining whether the modifications result in the establishment of new contracts or the continuation of existing contracts. Additionally, stakeholders indicated that financial reporting results should reflect the intended continuation of such contracts and arrangements during the period of the market-wide transition to alternative reference rates. In response to these concerns, the FASB provided the following optional expedients for contracts that are modified because of reference rate reform, which do not require any additional analysis:

- Modifications to contracts within the scope of Topics 310, Receivables, and 470, Debt, may be accounted for as a continuation of the existing contract (i.e., by prospectively adjusting the effective interest rate).
- Modifications to contracts within the scope of Topics 840 and 842, Leases, may be accounted for as a continuation of the existing contracts with no reassessments of the lease classification and the discount rate (e.g., the incremental borrowing rate) or remeasurements of lease payments that otherwise would be required under those Topics for modifications not accounted for as separate contracts.
- Contract modifications do not require reassessment of whether embedded derivatives are considered clearly and closely related to the host contract under Subtopic 815-15, Derivatives and Hedging-Embedded Derivatives.
- For other Topics or industry Subtopics, the amendments also include a general principle that entities may consider in-scope contract modifications as events that do not require contract remeasurement or reassessment of previous accounting determinations (see illustrative examples in ASC 848-20-55-2).

To qualify for the optional expedients for contract modifications, other terms being concurrently modified need to be related to the replacement of a reference rate because of reference rate reform. The ASU includes guidance and examples for identifying when changes to the terms of the contract are related to the replacement of a reference rate and are eligible for the optional expedients. For example, a change to the maturity date is deemed unrelated to the replacement of a reference rate and, therefore, is not eligible for the expedients (see illustrative examples in ASC 848-20-15-5 through 15-6).

All elected expedients must be applied consistently to all eligible contract modifications within that Topic or Industry Subtopic. For example, if an entity elects the lease modification expedient, it must apply the optional expedient to all its lease contract modifications arising from reference rate reform that would otherwise be accounted for in accordance with Topic 840 or 842.

Hedge Accounting

Changes in a reference rate could disallow the application of certain hedge accounting guidance under Topic 815, Derivatives and Hedging, and certain hedging 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 could result in financial reporting outcomes that do not reflect entities' intended hedging strategies. Therefore, the following expedients and exceptions are provided in the ASU:

- **Changes in critical terms of a hedging relationship** – Under Topic 815, hedge accounting must be discontinued if the critical terms of a hedging relationship are modified. The ASU provides an exception to this guidance to allow the hedging relationship to continue without de-designation for certain changes in the critical terms of a hedging relationship. For example, an entity may change the reference rate or other contractual terms of a hedging instrument, a hedged item, or a forecasted transaction designated in a fair value hedge, cash flow hedge, or a net investment hedge, as applicable, so long as the changes are due to reference rate reform.

- **Excluded components** – Under Topic 815, entities may exclude a portion of the change in the hedging instrument's gain or loss from the assessment of hedge effectiveness. The ASU provides an optional expedient to change the systematic and rational method used to recognize the components excluded from hedge effectiveness assessment in earnings. In addition, if the changes to the contractual terms of the designated derivative cause a change in the fair value of the excluded component, an entity may elect to recognize the change in fair value of the excluded component in the same income statement line item that is used to present the earnings effect of the hedged item.

- **Shortcut method** – Topic 815 includes a list of qualifying conditions that, if met, an entity may assume no ineffectiveness in an interest rate swap (the "shortcut method"). For fair value and cash flow hedges, entities may disregard certain of the qualifying conditions that may not be met due to the reference rate reform (see ASC 848-40-25-8, 848-50-25-6, 848-50-35-5).

- **Fair value hedges** – For fair value hedging relationships where the designated benchmark rate being hedged is LIBOR or another rate that is expected to be discontinued because of the reform, the ASU allows entities to change the designated benchmark interest rate documented at hedge inception to a different eligible benchmark interest rate if the hedge is expected to remain highly effective. The ASU permits an entity to apply a method to change the designated benchmark interest rate that either adjusts the hedged item's cumulative fair value hedge basis adjustment or maintains the hedged item's cumulative basis adjustment. The method applied to change the designated benchmark interest rate must be reasonable and must be applied consistently across similar fair value hedging relationships.

- **Cash flow hedges** -
  - If the designated hedged interest rate risk in a cash flow hedge of a forecasted transaction is an affected rate, entities may continue to assert that the hedged forecasted transaction (e.g., the future interest receipts or payments of a financial instrument) remains probable.
  - Entities may continue hedge accounting following a change in the hedged interest rate risk if the hedging relationship remains highly effective, including under an optional expedient method provided in the ASU.
  - When either the hedging instrument or the hedged forecasted transaction reference an affected rate, entities may adjust the designated method used to assess initial and subsequent hedge effectiveness in order to disregard certain mismatches between the designated hedging instrument and the hedged item. This includes the shortcut method, the simplified hedge accounting approach for private companies, and application of other methods such as the hypothetical derivative method or the change-in-variable cash flows method that assume perfect hedge effectiveness when certain conditions are met.
  - For hedges of portfolios of forecasted transactions that reference an affected rate, entities may disregard the requirement in Subtopic 815-20 that the group of individual transactions must share the same risk exposure for which they are designated as being hedged.

Except for the expedient to change the designated benchmark interest rate in similar fair value hedges, all other optional expedients for hedge accounting may be elected on an individual hedging relationship basis.

Securities classified as Held-to-Maturity

The ASU allows entities to make a one-time election to sell or transfer (or both) any eligible debt securities classified as held to maturity to available for sale or trading. The one-time election to sell, transfer, or both sell and transfer debt securities classified as held to maturity may be made at any time after March 12, 2020 but no later than December 31, 2022.

Debt securities are eligible for this election if they:

- Were classified as held to maturity before January 1, 2020, and
- Reference a rate that is expected to be discontinued because of the reference rate reform

Entities that avail the one-time election are not required to apply it to all debt securities classified as held to maturity. The entity shall apply the measurement guidance for transfers of debt securities between categories in ASC 320-10-35-10 through 35-16, which requires the transferred security to be measured at fair value. The unrealized gain or loss at the date of transfer is recognized in earnings if the transfer is to trading classification or in other comprehensive income if reclassified to available-for-sale category. Further, the disclosure requirements in ASC 320-10-50-10 apply. The sale or transfer, in and of itself, would not call into question the entity's assertion at prior reporting dates that it had the intent and ability to hold those securities to maturity.

Effective Dates and Transition

Contract Modifications

An entity may elect to apply the amendments for contract modifications by Topic or Industry Subtopic as of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020, or prospectively from a date within an interim period that includes or is subsequent to March 12, 2020, up to the date that the financial statements are available to be issued. Once elected for a Topic or an Industry Subtopic, the amendments in this Update must be applied prospectively for all eligible contract modifications for that Topic or Industry Subtopic.

Hedging Relationships

An entity may elect to apply the amendments in the ASU to eligible hedging relationships existing as of the beginning of the interim period that includes March 12, 2020 and to new eligible hedging relationships entered into after the beginning of the interim period that includes March 12, 2020.

For private companies that are not financial institutions as described in ASC 942-320-50-1 and certain not-for-profit entities, an entity must update its hedge documentation noting the changes made before the next financial statements are available to be issued. For all other entities, an entity must update its hedge documentation noting the changes made no later than when the entity performs its first quarterly assessment of effectiveness after the election.

If an entity has not adopted the amendments in ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities, the entity may elect only the following optional expedients for hedge accounting:

1. An optional expedient allowing changes in critical terms of a hedging relationship;
2. An optional expedient allowing a change in the method designated for use in assessing hedge effectiveness in a cash flow hedge, if the optional expedient method being elected is the simplified hedge accounting approach for eligible private companies;
3. An optional expedient allowing the entity to assume that the hedged forecasted transaction in a cash flow hedge is probable of occurring;
4. An optional expedient allowing the entity to assume that the reference rate will not be replaced for the remainder of the hedging relationships for initial and subsequent hedge effectiveness when the entity is using any of the methods for assessing and measuring hedge effectiveness in a cash flow hedge on a quantitative basis and if both the hedged forecasted transaction and the hedging instrument have an eligible reference rate; or
5. An optional expedient allowing the entity to disregard certain requirements of the simplified hedge accounting approach for eligible private companies for initial hedge effectiveness or for subsequent hedge effectiveness in a cash flow hedge.

Sunset date

The amendments in the ASU do not apply to contract modifications made after December 31, 2022, new hedging relationships entered into after December 31, 2022, and hedging relationships evaluated for periods after December 31, 2022, except for hedging relationships existing as of December 31, 2022 for which an entity applies the following optional expedients that are retained through the end of the hedging relationship (including for periods evaluated after December 31, 2022):

1. An optional expedient to the systematic and rational method used to recognize in earnings the components excluded from the assessment of effectiveness;
2. An optional expedient to the discount rate for cash flows associated with the hedged item and any adjustment to the cash flows for the designated term or the partial term of the designated hedged item in a fair value hedge;
3. An optional expedient to not periodically evaluate certain conditions when using the shortcut method for a fair value hedge.

Disclosures

Entities are required to disclose the nature of and reason for their elections to apply expedients in each interim and annual period in the fiscal year of adoption.