No. 2020-07
13 March 2020

# To the Point

FASB – final guidance

## FASB provides accounting relief for the transition away from LIBOR and certain other reference rates

The final guidance will help to facilitate the market transition from existing reference interest rates to alternatives.

### What you need to know

- The FASB issued final guidance to provide temporary optional expedients and exceptions to the US GAAP guidance on contract modifications and hedge accounting to ease the financial reporting burdens of the expected market transition from LIBOR and other interbank offered rates to alternative reference rates, such as SOFR.
- Entities can elect not to apply certain modification accounting requirements to contracts affected by what the guidance calls reference rate reform, if certain criteria are met. An entity that makes this election would not have to remeasure the contracts at the modification date or reassess a previous accounting determination.
- Entities can elect various optional expedients that would allow them to continue applying hedge accounting for hedging relationships affected by reference rate reform, if certain criteria are met.
- Entities can make a one-time election to sell and/or reclassify held-to-maturity debt securities that reference an interest rate affected by reference rate reform.
- The guidance is effective upon issuance and generally can be applied through 31 December 2022.

## Overview

The Financial Accounting Standards Board (FASB or Board) issued **final guidance**[1] to provide temporary optional expedients and exceptions to the guidance in US GAAP on contract modifications and hedge accounting to ease the financial reporting burdens related to the expected market transition from the London Interbank Offered Rate (LIBOR) and other interbank offered rates to alternative reference rates, such as the Secured Overnight Financing Rate (SOFR).

EY
Building a better working world

The guidance simplifies the accounting for modifying countless contracts (including those in hedging relationships) that refer to LIBOR and other interbank offered rates. Regulators in various jurisdictions have been working to replace these rates with reference interest rates that are supported by transactions in liquid and observable markets and are, therefore, less susceptible to manipulation.

In response to feedback from constituents, the FASB also allowed entities to make a one-time election to sell and/or transfer to available for sale or trading any held-to-maturity (HTM) debt securities that refer to an interest rate affected by reference rate reform and were classified as HTM before 1 January 2020. The last date this single election can be made is 31 December 2022.

While the new guidance is expected to mitigate the cost and complexity of accounting for modified contracts and the potential for earnings volatility, companies still need to focus on operational, legal, information technology and risk management issues related to the transition. Companies also need to consider disclosures and the sufficiency of the controls over their transition processes. The Securities and Exchange Commission staff has said it expects registrants to make disclosures about how they are preparing for the phaseout of LIBOR and other interbank offered rates, as well as and any anticipated effects that would be material.

## Key considerations

### Contract modifications

Modified contracts that meet the following criteria are eligible for relief from the modification accounting requirements in US GAAP:

- The contract references LIBOR or another rate that is expected to be discontinued due to reference rate reform.
- The modified terms directly replace or have the potential to replace the reference rate that is expected to be discontinued due to reference rate reform.
- Any contemporaneous changes to other terms (i.e., those that don't directly replace or have the potential to replace the reference rate) that change or have the potential to change the amount and timing of contractual cash flows must be related to the replacement of the reference rate.

The guidance includes examples of changes to contractual terms that would be considered related to the replacement of the reference rate and those that generally would not because the determination may not always be straightforward. For example, it says that adding or changing contractual fallback terms would be considered related to reference rate reform if the changes are consistent with the fallback terms developed by a regulator or by a private-sector working group convened by a regulator.

For a contract that meets the criteria, the guidance generally allows an entity to account for and present modifications as an event that does not require contract remeasurement at the modification date or reassessment of a previous accounting determination. That is, the modified contract is accounted for as a continuation of the existing contract. Specific guidance is provided for contracts that meet the criteria and are accounted for under the following topics:

| ASC topic | Relief |
|---|---|
| Accounting Standards Codification (ASC or Codification) 310, *Receivables,* or ASC 470, *Debt* | An entity accounts for the contract as if the modification were only minor (ASC 310-20) or not substantial (ASC 470-50).<br>As a result, the modification is accounted for by prospectively adjusting the effective interest rate in the agreement. |
| ASC 842, *Leases,* or ASC 840, *Leases* | An entity does not reassess lease classification and the discount rate, remeasure lease payments, or make other reassessments or remeasurements; the lease is accounted for as a continuation of the existing contract. |
| Embedded derivatives in the scope of ASC 815, *Derivatives and Hedging* | An entity does not reassess its conclusion about whether the contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract under ASC 815-15-25-1(a). |

Entities that elect to apply the relief need to apply it consistently for all eligible modified contracts accounted for under a particular Codification topic or industry subtopic.

### Hedge accounting

The guidance provides various optional expedients for hedging relationships affected by reference rate reform, if certain criteria are met.

For all types of hedging relationships (i.e., fair value, cash flow and net investment), the guidance allows an entity to change the reference rate and other critical terms related to reference rate reform without having to dedesignate the relationship.

Changes to the critical terms of a hedging relationship affected by reference rate reform will not require entities to dedesignate the relationship.

If a component of the hedging instrument is excluded from the assessment of hedge effectiveness, the entity can elect to change the systematic and rational method it uses to recognize this component in earnings over the remaining life of the hedge. In addition, if the changes to a hedging instrument's contractual terms result in a change in the fair value of the excluded component, an entity may elect to recognize that change in fair value in current earnings.

The guidance also allows entities to rebalance a fair value or cash flow hedge affected by reference rate reform without having to dedesignate the hedging relationship. In addition, entities are permitted to continue applying the shortcut method for existing fair value and cash flow hedges, even though certain requirements to apply this approach would no longer be met (e.g., the requirement that the formula for computing net settlements under the interest rate swap is the same for each net settlement).

#### *Fair value hedges*

For fair value hedging relationships in which the designated benchmark interest rate is LIBOR or another rate that is expected to be discontinued, an entity may change the hedged risk to another benchmark interest rate that is permitted under ASC 815 without dedesignating the relationship, as long as the hedge is expected to remain highly effective. The guidance also addresses how to account for the change in the designated benchmark rate and the effect of this change on the cumulative basis adjustment to the hedged item.

#### *Cash flow hedges*

For cash flow hedges in which the designated hedged risk is LIBOR or another rate that is expected to be discontinued, the guidance allows an entity to assert that it remains probable that the hedged forecasted transaction will occur.

Other optional expedients provide relief from various hedge effectiveness requirements for both new and existing cash flow hedges affected by reference rate reform. This relief allows an entity to change the designated method used to assess hedge effectiveness and simplifies or temporarily suspends the assessment of hedge effectiveness for these hedging relationships.

### How we see it

Financial institutions that are not public business entities and have not yet adopted Accounting Standards Update (ASU) 2017-12[2] should consider doing so before changing the reference rate in hedging instruments or hedged items, particularly if these changes will not be made simultaneously.

That's because the guidance prohibits these entities from electing many of the optional expedients related to hedge accounting. They can apply certain expedients that allow hedge accounting to continue without dedesignation, but they would generally need to consider all differences between the hedged item and the hedging instrument in the assessment and measurement of hedge ineffectiveness, which could increase complexity. This complexity could also exist for other entities that hedge variable rate assets and have not yet adopted ASU 2017-12.

Entities can generally elect to apply the optional expedients related to hedge accounting on a hedge-by-hedge basis.

## Effective date and disclosures

The guidance is effective upon issuance. The guidance on contract modifications is applied prospectively from any date beginning 12 March 2020. It may also be applied to modifications of existing contracts made earlier in the interim period that includes the effective date (i.e., modifications made as early as 1 January 2020 for a calendar-year company).

The guidance on hedging is applied to eligible hedging relationships existing as of the beginning of the interim period that includes the effective date (i.e., 1 January 2020 for a calendar-year company) and to new eligible hedging relationships entered into after the beginning of that interim period.

The relief is temporary and generally cannot be applied to contract modifications that occur after 31 December 2022 or hedging relationships entered into or evaluated after that date. However, certain optional expedients can be applied to hedging relationships evaluated in periods after 31 December 2022.

Entities that elect the relief are required to disclose the nature of the optional expedients and exceptions they are applying and their reasons for doing so.

**Endnotes:**

[1] ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*.

[2] ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. While public business entities have already adopted the ASU, the FASB has deferred the effective date for all other entities to fiscal years beginning after 15 December 2020 and interim periods in fiscal years beginning after 15 December 2021.

EY | Assurance | Tax | Transactions | Advisory

© 2020 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 08548-201US

ED None

ey.com/us/accountinglink

**About EY**
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.