The FASB’s proposal would help facilitate the market transition from existing reference interest rates to alternatives.

What you need to know

- The FASB proposed providing temporary optional expedients and exceptions to the US GAAP guidance on contract modifications and hedge accounting in light of the expected market transition from LIBOR and other reference interest rates to alternatives, such as SOFR.

- Under the proposal, an entity could choose not to apply certain modification accounting requirements in US GAAP to contracts affected by what the proposal calls reference rate reform, if certain criteria are met. An entity that made this election would present and account for a modified contract as a continuation of the existing contract.

- The proposal would also provide optional expedients that would enable entities to continue to apply hedge accounting for hedging relationships in which the critical terms change due to reference rate reform, if certain criteria are met.

- The relief would be effective upon issuance, and entities would be able to apply it prospectively through 31 December 2022. Comments are due by 7 October 2019.

Overview

The Financial Accounting Standards Board (FASB or Board) proposed providing optional expedients and exceptions to the guidance in US GAAP on contract modifications and hedge accounting in light of the expected market transition from the London Interbank Offered Rate (LIBOR) and other interbank offered rates to alternative reference interest rates.
Under the proposal, an entity could choose not to apply certain modification accounting requirements in US GAAP, if certain criteria are met. An entity that made this election would present and account for a modified contract as a continuation of the existing contract. This aspect of the proposal would affect both financial and commercial contracts.

In addition, the proposal would provide optional expedients that would enable entities to continue to apply hedge accounting for hedging relationships in which the critical terms change due to reference rate reform, if certain criteria are met.

The relief would be temporary and could not be applied to contract modifications that occur after 31 December 2022 or hedging relationships entered into or evaluated after that date.

Background
LIBOR is used extensively in the US and global markets as a reference interest rate in a broad range of financial instruments and commercial agreements, but the banks that report information used to set this rate will no longer be required to do so after 2021.

Regulators in various jurisdictions have been working to replace LIBOR and other interbank offered rates with reference interest rates that are more firmly based on actual transactions from deep and liquid markets. For example, in the US, the Alternative Reference Rates Committee convened by the Federal Reserve has identified the Secured Overnight Financing Rate (SOFR) as its preferred alternative to US dollar LIBOR.1

The transition to new reference interest rates will require countless contracts (e.g., derivative contracts, variable rate debt agreements) to be modified. The proposal is intended to mitigate the effect of this transition on financial reporting.

How we see it
Without this relief, accounting for changes to contracts stemming from reference rate reform would be costly and burdensome to apply and could have significant effects on financial reporting, including increased earnings volatility. While the proposal would help mitigate these effects, companies would still need to focus on operational, legal, information technology and risk management considerations related to the transition.

The staff of the Securities and Exchange Commission (SEC) has emphasized the importance of registrants keeping investors informed about their progress in managing the transition away from LIBOR and other existing reference interest rates.

Key considerations
Contract modifications
Under the proposal, modified contracts that meet the following criteria would be eligible for relief from the modification accounting requirements in US GAAP:

- The contract references LIBOR or another reference interest rate that is expected to be discontinued due to reference rate reform.
- The modified terms change, or have the potential to change, the amount and timing of contractual cash flows and would directly replace or have the potential to replace a 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 a 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 proposal includes examples of changes to contractual terms that would be considered related to the replacement of the reference rate and those that wouldn't because the determination may not always be straightforward. For example, the proposal notes that changes to the strike price of an embedded interest rate option would be considered related to reference rate reform.

For contracts that meet these criteria, the proposal generally would allow an entity to account for and present the modified contract as a continuation of the contract that existed before the modification for reference rate reform rather than a derecognition (or extinguishment) of a contract and the initial recognition of a new contract.

In addition, the proposal would provide specific relief for contracts that meet the above criteria and are accounted for under the following topics:

<table>
<thead>
<tr>
<th>ASC topic</th>
<th>Proposed relief</th>
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<tr>
<td>Accounting Standards Codification (ASC or Codification) 310, Receivables, or ASC 470, Debt</td>
<td>An entity would account for the contract as if the modification were only minor (ASC 310-20) or not substantial (ASC 470-50). As a result, the contract would be accounted for as a continuation of the existing contract.</td>
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<td>ASC 842, Leases</td>
<td>An entity would not reassess lease classification and the incremental borrowing rate, remeasure lease payments, or make other reassessments or remeasurements that would otherwise be required. Instead, the contract would be accounted for as a continuation of the existing contract.</td>
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<td>Embedded derivatives in the scope of ASC 815, Derivatives and Hedging</td>
<td>An entity would not change its conclusion on whether the contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract in accordance with ASC 815-15-25-1(a).</td>
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If an entity elected to apply the proposed guidance, it would need to do so for all modified contracts that otherwise would be accounted for in accordance with the same accounting topic, subtopic or industry subtopic in the Codification.

**Hedge accounting**

For hedging relationships in which the hedging instrument, the hedged item or the hedged forecasted transaction references LIBOR or another reference interest rate that is expected to be discontinued due to reference rate reform, the proposal would provide optional expedients to enable entities to change critical terms and continue to apply hedge accounting, if certain criteria are met. Entities would be able to elect each expedient on a hedge-by-hedge basis. However, they would have to have adopted the new hedge accounting guidance to apply the relief.

For all types of hedging relationships (i.e., fair value, cash flow and net investment), the proposal would allow an entity to change the critical terms of a designated hedging instrument without having to redesignate the hedging relationship, if the criteria for relief from the contract modification accounting requirements are met. An entity would also be allowed to rebalance a fair value or cash flow hedge affected by reference rate reform without having to redesignate the hedging relationship.

The proposal would also provide relief for existing fair value and cash flow hedges in which the shortcut method is applied. Entities would be allowed to continue to apply the shortcut method for the remainder of the hedging relationship, even though certain requirements to apply this approach would no longer be met as a result of reference rate reform (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 existing fair value hedging relationships affected by reference rate reform, the proposal would allow an entity to change the designated benchmark interest rate documented at hedge inception to a different benchmark interest rate that is permitted under ASC 815 without redesignating the relationship, as long as the hedge is expected to remain highly effective. The proposal would also provide entities with certain flexibility in how they 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 reference interest rate that is expected to be discontinued due to reference rate reform, the proposed guidance would allow an entity to assert that it remains probable that the hedged forecasted transaction will occur.

The proposal would also provide optional expedients that would give entities relief from certain hedge effectiveness requirements for both new and existing cash flow hedges affected by reference rate reform. These expedients are intended to make it easier to continue applying hedge accounting for hedging relationships affected by reference rate reform.

**How we see it**
Before the FASB issues any final guidance, entities should continue to consider the comments previously made by the SEC staff regarding the potential effect of reference rate reform on hedge accounting.³

In response to questions received from a stakeholder regarding cash flow hedges of LIBOR-based variable rate debt that extends beyond the anticipated transition away from LIBOR, the SEC staff indicated that it would not object to either of the following views:

- The hedged forecasted transactions can continue to be considered probable of occurring even though future interest payments may be based on a revised reference rate.
- The effectiveness of the hedging relationship would not be affected by the anticipated transition away from LIBOR because the anticipated changes are expected to affect both the hedged item and the hedging instrument.

Although the views expressed by the SEC staff are much narrower than the relief the FASB has proposed, we believe they are helpful for entities that are considering the potential effects of reference rate reform on certain existing hedging relationships before the transition to new reference interest rates.

**Endnotes:**

1 The FASB has already added the Overnight Index Swap Rate based on SOFR to the list of US benchmark interest rates eligible to be hedged under US GAAP.
2 Accounting Standards Update 2017-12, Targeted Improvements to Accounting for Hedging Activities.
3 The staff provided this view in a speech at the 2018 AICPA Conference on Current SEC and PCAOB Developments.