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Interest Rate Benchmark Reform: Accounting and Reporting

21 September 2020

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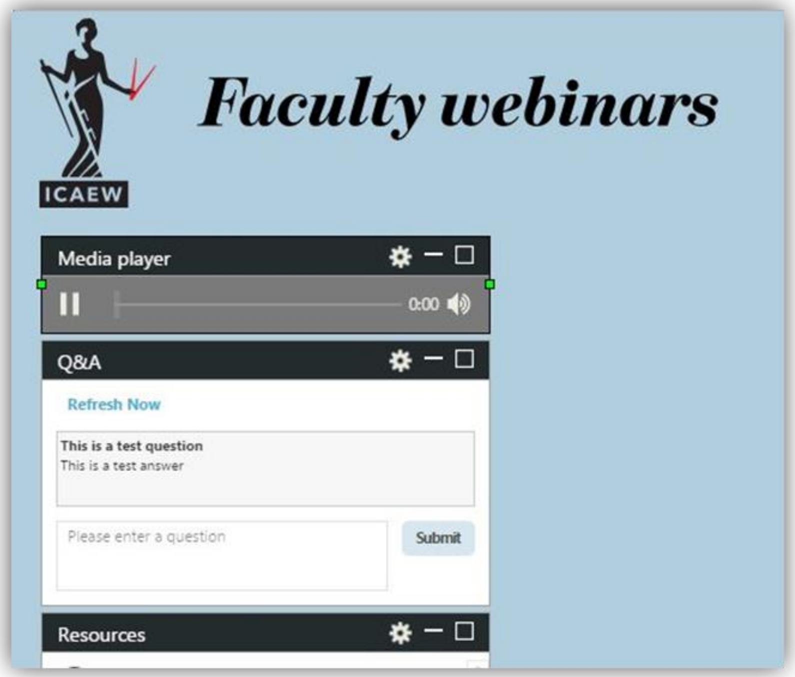

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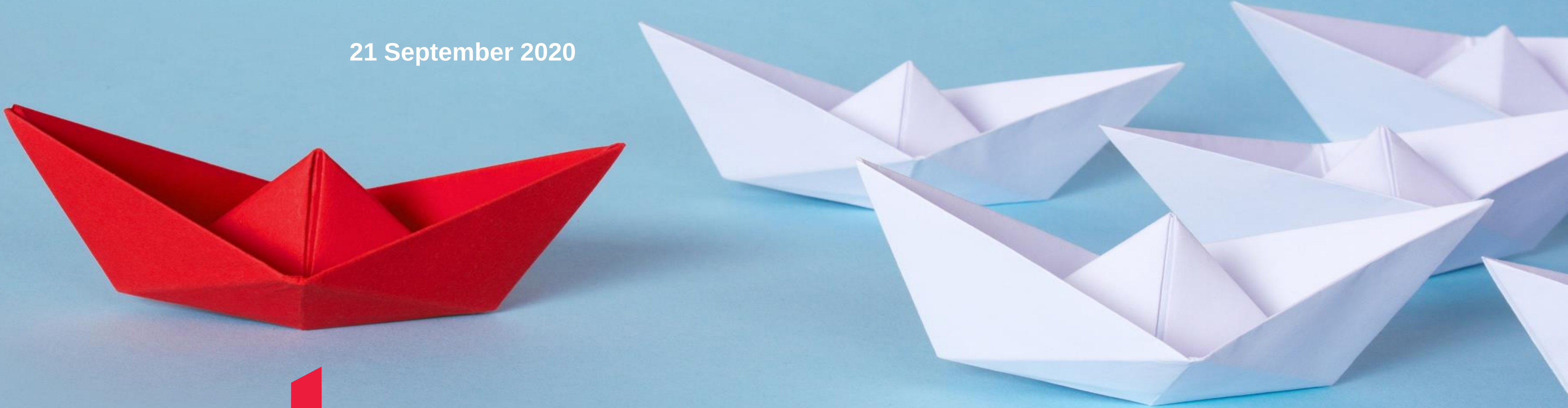
IBOR Reform and the Effects on financial reporting: Phase 2

21 September 2020



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AGENDA

01
Introduction and current status

02
Modifications of financial instruments

03
Hedge Accounting amendments (including Transition)

04
Financial instrument disclosure amendments

05
Other amendments (for IFRS 16 Leases and IFRS 4 Insurance Contracts)

06
Other areas not amended by the exposure draft

INTRODUCTION AND CURRENT STATUS

- As part of its on-going work on Interbank Offered Rates (IBOR) Reform, the IASB published an Exposure Draft (ED) on **9th April 2020**.
- This had an accelerated 45-day comment period, which closed on **25th May 2020**.
- This second series of proposed amendments focused on **replacement issues**.
- These are those issues that affect accounting and financial reporting **at the time** that Reform takes place, i.e. when an IBOR is replaced with an alternative Risk Free Rate (RFR).
- It proposes targeted reliefs, amendments and clarifications to **better reflect the economic substance of underlying transactions that are a direct consequence of IBOR Reform**.
- The ED addressed:
  - Modifications of financial instruments;
  - Hedge accounting;
  - Lease contract accounting;
  - Insurers; and
  - Transition and disclosure.

- The amendments would be effective for annual periods beginning **on or after 1 January 2021**.
- Early application would be permitted **but** this needs to be first endorsed by the EU.
- The application of the amendments **is mandatory and retrospective**.

- ❑ **The IASB Board met on 25th June and 22nd to 23rd July 2020 to discuss the feedback on the ED and finalised the proposed amendments.**
- ❑ **The final amendments were published on 27th August 2020.**

- ❑ **The FRC issued FRED 74 Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* Interest rate benchmark reform (Phase 2) in May 2020.**
- ❑ **Comment period closes in September 2020.**
- ❑ **Broadly similar to the IASB's proposed amendments.**

- ❑ **Amendments relates to transactions and not any particular industry sector(s).**

MODIFICATIONS OF FINANCIAL INSTRUMENTS

What constitutes a modification in IBOR Reform

- A modification under IFRS 9 Financial Instruments (IFRS 9) does not **necessarily require an amendment** to the contractual terms of a financial instrument.
- A change in the basis on **which contractual cash flows are determined** constitutes a modification as long as it is economically equivalent.
- **However**, must be required as a direct consequence of IBOR Reform.

Examples of modifications related to IBOR Reform

- **Replacing** an existing benchmark rate with an alternative benchmark rate.
- Changing the **method used to calculate** the interest rate benchmark.
- Adding a **fixed spread to compensate** for a difference between existing and alternative benchmark rates.
- Changing the **reset period, reset dates or number of days** between interest payment dates.
- Adding **fallback provisions** to contractual terms to effect any of the changes described above.

Practical expedients for such modifications

- Practical expedient to **allow contractual changes or changes to cash flows** that are directly required by IBOR Reform to be **treated as changes to a floating interest rate** (equivalent to movement in market interest rate).
- Entity required to **first identify and account for modifications** to financial instruments which relate directly to IBOR Reform by updating the effective interest rate without adjusting the carrying amount.

MODIFICATIONS OF FINANCIAL INSTRUMENTS

Discussion at June and July IASB Board Meetings

- The Board decided to finalise the proposals set out in the ED on **modifications of financial instruments** without substantial changes.
- The Board also decided to **make no substantial changes** to the proposals in the ED in response to issues related to:
  - **Classification of financial assets**, in terms of IFRS 9's contractual cash flow test vis-à-vis the principal amount outstanding; and
  - **Embedded derivatives**.

HEDGE ACCOUNTING AMENDMENTS

Exceptions to hedge designation / documentation

- To allow changes required by IBOR Reform to be made to hedge designations and hedge documentation under both IFRS 9 / IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) **without discontinuation of hedge accounting**.
- Includes redefining **hedged risk** to a RFR and the description of the hedging instruments and / or the hedged items to reflect the RFR.
- IAS 39 to be amended so that changes to the method for assessing **hedge effectiveness** due to IBOR Reform will not result in discontinuation of hedge accounting.

Re-measurement on transition to RFR

- At the time the hedge designation / documentation is amended to refer to a RFR:
  - For **fair value hedges**, hedging instrument and / or hedged item are **remeasured** based on RFR.
  - For **cash flow hedges**, cash flow hedge reserve is remeasured based on the RFR to **the lower** of the hedging instrument's cumulative gain or loss and the hedged item's cumulative change in fair value.
  - Differences **recognised in profit or** loss in the normal manner.

Amounts accumulated in cash flow hedge reserve

- Relief requires the amount accumulated in the cash flow hedge reserve to **be deemed to be based** on the alternative benchmark rate when there is a change in the basis for determining the contractual cash flows.
- This **includes** amounts related to hedge accounting relationships that were previously discontinued but did not warrant recycling to profit or loss.

Relief for hedge of groups of items and portfolio hedge

- To allow the hedging strategy to remain and **not be discontinued** as groups of hedged items are modified for changes arising as a result of IBOR Reform.
- As items within the hedge of a sub-group of items may transition at different times from IBOR to RFR, then the requirements will be applied at a sub-group of items level vis-a-vis the hedged risk.

HEDGE ACCOUNTING AMENDMENTS

Designation of risk components

- Temporary relief for entities for the separately identifiable requirement under IFRS 9 / IAS 39 for risk components, when an hedging instrument is designated as a hedge of the risk component.
- Entities can **now assume** that the separately identifiable requirement is met, provided there is expectation that the risk component will be separately identifiable **within a period of 24 months** from the date the alternative benchmark rate is designated.

Application of amendments

- Application would be **mandatory and retrospective**.
- Entity **not required to restate prior periods** to reflect application of amendments **but may** restate prior periods only if it is possible **without use of hindsight**.
- This would involve **reinstating** hedge accounting relationships that have been discontinued solely due **to** changes directly required by IBOR Reform.
- If do not restate, **recognise differences in in opening retained earnings at date of initial application** (DIA).

Retrospective in/effectiveness under IAS 39

- For the assessment of retrospective hedge effectiveness, cumulative fair value **may be reset to zero** at the point of the Reform.
- Hedge ineffectiveness **continues** to be measured and recognised in full in profit or loss.

HEDGE ACCOUNTING AMENDMENTS

Discussion at June and July IASB Board Meetings

- The Board decided to finalise the proposals set out in the ED in relation to hedge accounting relationships subject to clarification, which included:
  - Examples of modifications required by the Reform that would be incorporated as part of changes;
  - Include specific reference to **portions of designated hedged item** included as part of required changes; and
  - Changes have to be **made by end of the reporting period** during which uncertainty with respect to a specific element has been resolved.
- The Board also decided to finalise the proposals for designation of risk components on a **rate-by-rate basis** subject to clarifying that the 24-month period applies to the alternative benchmark rate **when designated**.
- The Board decided to finalise the proposals on transition requirements with one change clarifying requirement to reinstate discontinued hedge accounting relationships if was **solely because** of the Reform and **still met all qualifying criteria**.
  - 24-month period **begins from** the amendment's DIA.
- The Board also decided to clarify that IBOR Reform could give rise to changes to hedging instruments in addition to **modifying their contractual terms** of the hedging instrument.
  - Relief still available as long as hedging instrument not derecognised and outcome economically equivalent to modifying to refer to alternative benchmark rate.
- The Board decided to **allow** the resetting of the cumulative fair value for the purposes of performing IAS 39 effectiveness testing to zero as opposed to require it.
- The Board also decided to clarify that any **remeasurement differences** are recognised in the extant manner, i.e. in profit or loss.

FINANCIAL INSTRUMENT DISCLOSURE AMENDMENTS

Additional disclosures

- Required to provide disclosures for users to understand:
  - The nature and extent of risks arising from IBOR Reform to which entity is exposed to;
  - How it manages those risks;
  - Progress of entity in completing transition to alternative benchmark rates; and
  - How it is managing this transition.

FINANCIAL INSTRUMENT DISCLOSURE AMENDMENTS

Discussion at June and July IASB Board Meetings

- The Board decided to finalise the proposed disclosure amendments subject to clarification, which included:
  - Requiring **separate disclosure of quantitative information** about non-derivative financial assets and liabilities and derivatives that, at the end of the reporting period, remain referenced to benchmark rates that are being Reformed; and
  - **Disaggregate** this by significant benchmark rate **and choose and explain the representative basis** for disclosing the quantitative information.

OTHER AMENDMENTS

Lease contract accounting and IBOR Reform

- Practical expedient to allow for lease modifications directly required by IBOR Reform to be **treated as changes to a floating interest rate** under IFRS 16 Leases (IFRS 16).

Insurers applying IFRS 4 temporary exemption

- The practical expedient to modifications of financial instruments under IFRS 9 would also be applied by entities **applying the IFRS 4 Insurance Contracts (IFRS 4) amendments**, by virtue of which they are still applying IAS 39.

OTHER AMENDMENTS

Discussion at June and July IASB Board Meetings

- The Board decided to finalise the proposals set out in the ED on modifications of leases and insurers applying the temporary exemption from IFRS 9 without substantial changes.

OTHER AREAS NOT AMENDED BY THE EXPOSURE DRAFT

Discount rates

- No amendments proposed to the requirements pertaining to discount rates.
- The Board concluded that applying the requirements in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors (IAS 8) for accounting for changes in a discount rate as a result of the Reform provides an appropriate basis to determine the accounting treatment and provides useful information to users of financial statements.

IFRS 17 Insurance Contracts

- No amendment to IFRS 17 Insurance Contracts (IFRS 17) to account for modifications to insurance contracts required by IBOR Reform as it is not envisaged that fulfilment cash flows would change substantially as a result of the Reform.
- The Board concluded that requirements in IFRS 17 in accounting for modifications, including those required by the Reform, would faithfully represent the economic effects.

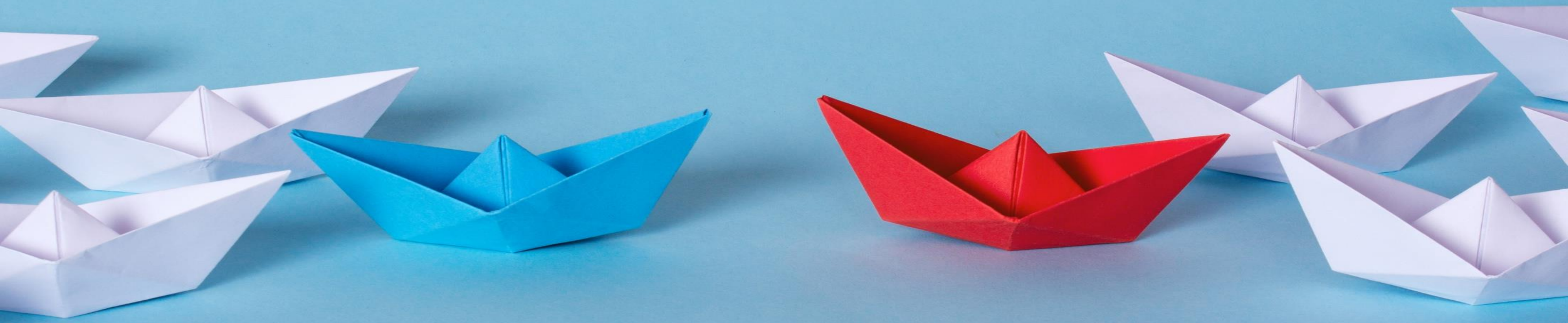
IFRS 13 Fair Value Measurement

- No amendments to IFRS 13 Fair Value Measurement (IFRS 13) in terms of the measurement and disclosure requirements.
- The Board concluded that changes to, e.g. the fair value hierarchy disclosure requirements, would result in a loss of useful information being provided to users of financial statements and would therefore be inconsistent with the objective of the amendments.

CONCLUDING REMARKS

As one can see, the Reform can impact the following areas:

Accounting	Valuations	Operations	Systems
Tax	Governance and risk frameworks	Controls assurance and attestation	Conduct



CONCLUDING REMARKS

Some of the things you should you be thinking about amongst others:

- Analyse when different financial statement line items will be affected by IBOR Reform.
- Assess the wording of the amendments and consider such in light of current and future financial statement line items that will be affected.
- Establish a strategy for modifying financial instruments knowing that not all modifications may fall within the proposed relief.
- Review nature and extent of impact on previous, current and future hedge accounting relationships.
- Consider whether and able to reinstate discontinued hedges and the implications of this.
- Review the performance of hedge effectiveness testing under IAS 39.
- Determine what to disclose in the financial statements.
- Applying of judgement overall (e.g. in relation to the 24-month separately identifiable requirement).

CONCLUDING REMARKS

Auditors are, amongst other things, interested in:

01
Understanding the extent of IBOR exposure

02
Impact of change in rates and methodologies

03
Interpretation and application of accounting requirements

04
Governance, including processes and controls, to mitigate risks

05
Depth and richness of disclosure

06
Potential conduct matters given the lack of perfect markets

Will overall be interested in how the entity is approaching the transition from IBOR to RFRs

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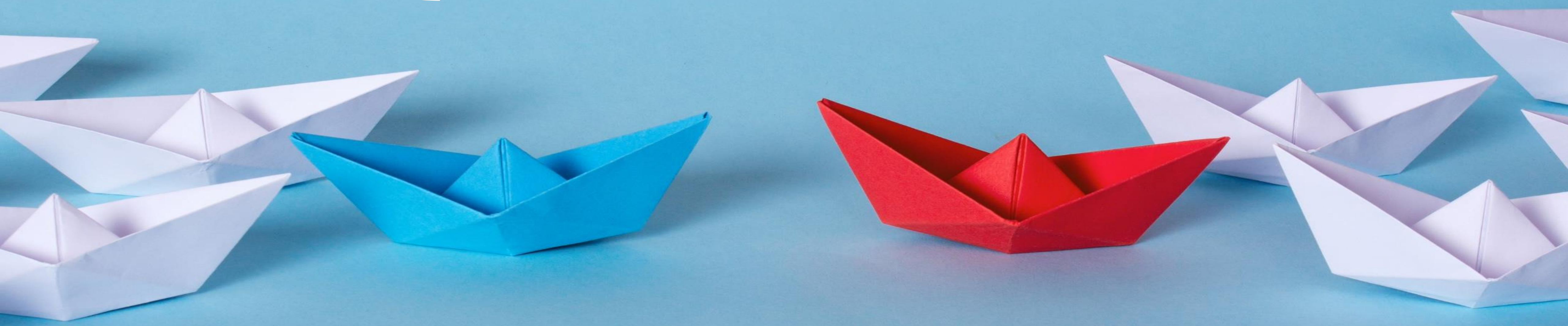
Q&A



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