Issue 154 / October 2019

IFRS Developments

IBOR reform: IASB discusses phase two classification and measurement issues

What you need to know

- At its October meeting, the IASB made progress in phase two of its project to amend IFRS in response to the financial reporting challenges posed by IBOR reform.
- The IASB agreed solutions to address the phase two issues associated with the classification and measurement of financial instruments.
- The solutions include clarifying how existing IFRS should be applied, adding illustrative examples and amending IFRS where necessary.
- In November the IASB will discuss the issues associated with hedge accounting. The IASB plans to conclude its phase two discussions during Q1 2020.

Introduction

At its meeting on 23 October 2019, the International Accounting Standards Board (IASB or the Board) made significant further progress in its project to address the financial reporting issues associated with IBOR reform. In this publication, we summarise the tentative decisions taken and provide our view of how we see it.

Following the decision taken by global regulators to replace Interbank Offered Rates (IBORs) with replacement benchmark interest rates or risk-free rates (RFRs), in 2018, the IASB commenced work to address the effects of IBOR reform on financial reporting. The IASB has divided its work into two phases:

- Phase one addresses issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an alternative nearly risk-free interest rate
- Phase two focuses on issues that affect financial reporting when an existing interest rate benchmark is replaced with an RFR

On 26 September 2019, the IASB completed phase one with the publication of *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7*.

On 23 October 2019, the IASB reached tentative conclusions on the phase two issues relating to classification and measurement. In November and December, the IASB will discuss the phase two issues associated with hedge accounting.

We provide background to the IASB's project in *IFRS Developments 144* and *145*, and the phase one amendments in *IFRS Developments 152*. These publications can be found at www.ey.com/ifrs.

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Determining whether a modification has occurred

IFRS does not presently define what constitutes a modification of a financial instrument. For example, if the methodology used to set an existing benchmark interest rate is amended to meet the new regulatory requirements, but no amendments are made to the instrument's contractual terms, it is not clear whether a modification of the instrument has occurred.

The Board discussed this issue and agreed that IFRS should be amended to clarify that even if the contractual terms of a financial instrument remain unchanged, if the basis on which the contractual cash flows are set changes from that which was originally anticipated when the financial instrument was first entered into, this constitutes a modification.

Determining whether a modification is substantial

IFRS contains guidance to assess the effect of modifications on financial liabilities. Modifications which lead to terms that are substantially different from the original terms, result in derecognition. This guidance is also applied to assets, by analogy.

The Board noted that some modifications that may arise in the context of IBOR reform could be assessed qualitatively to determine whether they are substantial. At the October meeting, the Board considered whether to provide examples of such modifications but decided not to do so on the basis that it would risk widening the scope of the IBOR reform project and, as a result, could delay finalisation of the phase two amendments.

Some discussion may be provided in the Basis for Conclusions of the phase two amendments to direct preparers towards existing guidance on identifying whether modifications are substantial.

Accounting for modifications related to IBOR reform

For modifications which arise as a result of IBOR reform that are not considered to be substantial, and so the financial instrument is not derecognised, the IASB considered how the effect of the changes should be reflected. The IASB agreed to include a practical expedient in IFRS 9 *Financial Instruments* to allow contractual changes, or changes to cash flows that relate to the reform, to be treated as changes to a floating interest rate, equivalent to a movement in a market rate of interest. Inherent in allowing use of this practical expedient is the requirement that the transition from an IBOR benchmark rate to an RFR, takes place on an economically equivalent basis with no value transfer having occurred.

In applying this practical expedient, an entity is required to first identify and account for modifications to the instrument which relate directly to IBOR reform, by updating the effective interest rate (EIR) without adjusting the carrying amount. Any other modifications to the financial instrument that may be made at the same time, such as a change in the credit spread or maturity date, are assessed and if they are not substantial, the updated EIR should be used to recalculate the carrying amount of the financial instrument, with any modification gain or loss recognised in profit or loss.

It was agreed to add examples to IFRS 9 of the types of modifications that would likely be considered as related to IBOR reform and the types of modifications that would not. Also, an illustrative example would be included to demonstrate how the approach would be applied, including the order in which the different types of modifications should be reflected.

Accounting implications from derecognition of a modified financial instrument

The Board assessed whether, once it has been determined that a modification arising is substantial, and so the financial instrument should be derecognised, the existing IFRS provides useful information in the context of IBOR reform.

- When a financial asset is derecognised, an entity is required to recognise in profit and loss any difference arising between the carrying amount of the financial asset being derecognised and the consideration received. Similarly, when a financial liability is extinguished, an entity recognises in profit or loss any difference between the carrying amount of the financial liability and the consideration paid. The IASB agreed that IFRS provides an adequate basis to account for the gain or loss arising as a result of derecognition due to a substantial modification arising from IBOR reform, and that no further clarification or additional guidance is required.

- The derecognition of a financial asset and recognition of a new financial asset as a result of a substantial modification could potentially call into question whether an entity's business model continues to be appropriate. The IASB concluded that such a change would not in itself necessarily lead to a change in the entity's business model. This is because the entity determines its business model depending on whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Assuming the entity's way of managing the assets has not changed, the entity will not change its business model solely as a consequence of the derecognition event.

- For the 'solely payments of principal and interest' (SPPI) assessment, the Board considered whether, if IBORs are replaced with, for example, backward-looking term rates (such as a rate for the next six months based on the average overnight rate for the previous six months), this would cause instruments to fail the SPPI assessment on recognition of the new instrument and so would not qualify to be recorded at amortised cost. The IASB concluded that, provided the interest rate continues to reflect the time value of money and does not reflect other risks and features, the new instrument should pass the SPPI assessment. It was agreed that the principles in existing IFRS are sufficiently clear and no further guidance is required, but an example will be added to illustrate the guidance.

- Upon derecognition of a financial asset and recognition of a new asset, the Board considered how the expected credit loss (ECL) should be reflected. In particular, if an instrument prior to derecognition, was credit impaired, the question considered was whether, for the new instrument, the ECL should be recognised on a 12-month or lifetime basis. It was identified that if, as a result of the modification, the terms of the instrument were changed such that the credit quality had improved, a 12-month ECL would be appropriate. If, however, the instrument was deemed to be credit-impaired at origination, the guidance for the purchase of credit impaired assets would apply. The IASB decided that the existing IFRS guidance is sufficient and no amendment or clarification is required.

- The Board considered whether, if a new financial instrument included a fall-back provision (for instance, to specify that on transition, a rate of one-month LIBOR plus 100 basis points (bp) would be amended to the alternative benchmark rate plus 110bp) it would have to be separated as an embedded derivative. The IASB concluded that the current application guidance in IFRS 9 is sufficiently clear for preparers to determine whether the features of the fall-back would require separation.

Next steps

Having tentatively concluded on the classification and measurement issues, the IASB will next consider the consequential impacts on hedge accounting. These discussions are scheduled to take place during November and December. Other IFRS standards are due to be considered in December and January 2020 along with any new issues identified and disclosures.

If this timeline proceeds as envisaged, the IASB could publish an exposure draft by the end of the first quarter of 2020. If, as with phase one, the comment period for the exposure draft is limited to forty-five days, it could be possible for the IASB to publish the final phase two amendments before the end of quarter two or early in quarter three.

The timing is important because entities may, during 2020, accelerate their plans to complete the transition from IBORs to RFRs, especially during the second half of the year. Entities will need the phase two reliefs to have been finalised and available for their transition plans to progress.

How we see it

At its October meeting, the IASB took a significant step forwards in addressing the phase two issues. We are satisfied that the decisions taken should substantially resolve the classification and measurement issues that will arise once financial instruments transition to RFRs. We note that the decisions taken by the Board were tentative and can only be considered final once phase two of the IASB's project is complete.

We welcome the introduction of the practical expedient that the transition from a floating IBOR to a floating RFR should, in the absence of any other factors, be treated as a change to a floating interest rate. It is recognised that this necessitates an amendment to IFRS. However, if only limited numbers of instruments are amended before phase two is finalised, the effect from such modifications may be immaterial.

Also, provided it is clear that there are no changes to contractual terms other than those arising directly from IBOR reform, the practical expedient means entities should not have to perform a detailed review of the potentially large population of instruments to assess whether the modification is substantial.

We are encouraged that the decisions reached by the IASB keep to a minimum the extent to which existing IFRS must be amended. We are also pleased that the IASB are keeping the scope of the project reasonably narrow to avoid issues which could have wider implications and unintended consequences beyond those the IASB is trying to address. This should help allow the final amendments to be published sooner than might otherwise have been the case.

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EYG No. 004807-19Gbl

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