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IFRS Developments

IBOR reform: phase two (continued)

What you need to know

- At its January meeting, the IASB made further 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 majority of the remaining phase two issues associated with hedge accounting arising on transition to RFRs, along with related phase two disclosures.
- The impact of IBOR reform was also considered for other IFRSs relating to leases, insurance contracts and fair value measurement and solutions were agreed.
- The IASB plans to publish an exposure draft of the phase two amendments in April 2020.

Introduction

At its meeting on 30 January 2020, 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 views.

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 divided its work into two phases:

- Phase one addressed 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 is focused on issues that affect financial reporting when an existing interest rate benchmark is replaced with an RFR.

The IASB completed phase one with publication, in September, of, *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7*. In October, the IASB reached tentative conclusions on the phase two issues relating to classification and measurement. At its December meeting, the IASB reached tentative decisions on the phase two issues associated with hedge accounting on transition to RFRs.

At its January meeting, the IASB concluded on the phase two hedge accounting issues once the phase one reliefs end, along with the related disclosures, and the approach to be taken with respect to *IFRS 13 Fair Value Measurement*, *IFRS 16 Leases* and *IFRS 17 Insurance Contracts*.

For the background to the IASB's project, see our recent publications, *IFRS Developments 144* and *145;* we describe the phase one amendments in *IFRS Developments 152* and summarise the earlier phase two tentative decisions in *IFRS Developments 154* and *156*. These publications can be found at www.ey.com/ifrs.

Hedge accounting effects when the phase one reliefs end

The phase one amendments provide reliefs which allow entities to assume that the uncertainty arising from IBOR reform does not affect hedging relationships to the extent that they must be discontinued. The reliefs end at the earlier of:

- When the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk, or the timing and the amount of the interest rate benchmark-based cash flows of the hedged item or the hedging instrument; and
- When the hedging relationship that the hedged item, or the hedging instrument, is part of is discontinued.

In most cases, this means that once the instruments that form part of a hedging relationship are amended to replace references to IBOR with an RFR, this causes the uncertainty to cease and so the phase one reliefs end.

At the meeting in January, the IASB tentatively concluded on the accounting that will apply upon the end of application of the phase one reliefs to three different aspects of hedging relationships.

1. The highly probable requirement for cash flow hedges

For a cash flow hedge, the phase one reliefs allow an entity to assume that the designated IBOR-based cash flows are still expected to occur. Once the reliefs end, it must be determined how any amount deferred in the cash flow hedge reserve should be released.

Because it was agreed in October that a modification to contractual cash flows that is required by IBOR reform and made on an economically equivalent basis, is accounted for just as a change in the benchmark rate, the hedged risk is deemed to have continued despite it transitioning from IBOR to RFR. Further, it was decided in December that a hypothetical derivative in a cash flow hedge may be updated on transition, although any valuation adjustment on transition is recognised immediately in profit or loss. It follows that the remaining amount accumulated in the cash flow hedge reserve will be released to profit or loss in the same period or periods in which the hedged cash flows that are based on the RFR affect profit or loss. Consequently, at the January meeting, the IASB tentatively decided that no change was required to the phase one end of relief requirements for cash flow hedges.

2. The prospective assessments of hedge effectiveness

The phase one relief allows, for the prospective effectiveness assessments under IFRS 9 and IAS 39, cash flows of the hedged item and the hedging instrument to continue to be based on IBOR. This relief ends separately for each of the hedged item and the hedging instrument, when their respective uncertainty ceases. Hence, if the hedging instrument transitions to an RFR before the hedged item, the entity will have a mismatch, with the cash flows of the hedging instrument based on the RFR and those of the hedged item based on IBOR.

However, the January staff paper suggests that it is possible to minimise the ineffectiveness due to this mismatch by, for example, re-designating the hedge to be the hedge of the RFR risk. This relies on the tentative decision made at the December meeting, that necessary changes to the hedging relationships and the hedging documentation as instruments transition from IBOR to RFRs, do not result in discontinuation of hedge accounting. As a result, at the January meeting, the IASB tentatively decided that no additional guidance or amendments are required to the end of application requirement for the prospective assessment.

3. The IAS 39 retrospective test of hedge effectiveness

Although the relief provided in phase one ends when there is no longer uncertainty with respect to the cash flows of the hedged item **or** the hedging instrument, the staff paper for the January meeting implies this should be read to mean that the relief ends only when uncertainty ends for both the hedged item **and** the hedging instrument. Hence, the exception from applying the IAS 39 retrospective test of hedge effectiveness ceases when both the hedging instrument and the hedged item have transitioned from IBOR to RFR. However, actual hedge ineffectiveness will continue to be measured and recognised in full in profit or loss.

At the January meeting the IASB considered a scenario which could arise for hedging relationships once the transition is complete and the relief from the retrospective test ends. For entities that assess hedge effectiveness by comparing the cumulative change in fair value of the hedging instrument and the hedged item, if, on transition, the cumulative change is outside the 80% to 125% range, the hedge would immediately fail and have to be discontinued.

The IASB tentatively agreed that this outcome would be inconsistent with its objective to prevent hedging relationships being discontinued due to the uncertainty arising from IBOR reform. Therefore, IAS 39 will be amended so that for the assessment of retrospective hedge effectiveness, cumulative fair value changes will reset to zero when the exception to the retrospective assessment ends.

Additional phase two disclosures

Users of financial statements will benefit from disclosure of how entities are progressing the transition from IBOR to RFRs and whether it has given rise to any new or changed risks. The IASB tentatively agreed, at its January meeting, to amend *IFRS 7: Financial instruments: Disclosures*, to include the following additional disclosures:

- How the entity is managing the IBOR transition and the progress made
- The carrying amount of financial assets and liabilities, and nominal value of derivatives, that continue to reference IBORs, disaggregated by each significant IBOR benchmark
- For each RFR, an explanation of how the entity has determined the base rate and relevant adjustment to the base rate, to assess whether or not modifications have been made on an economically equivalent basis to determine whether derecognition is required
- Whether IBOR reform has given rise to any new risks and, if so, how the entity is managing those risks

Effects of IBOR reform on other accounting standards

At its January meeting, the IASB reached tentative decisions on whether other IFRS standards should be amended in response to IBOR reform.

- *IFRS 16 Leases* will include a practical expedient that for lessees, the transition of a lease referencing IBOR to RFR, will be treated as a change to a floating rate lease. Without this amendment, lessees would on transition have to remeasure the lease liability, discounted at the original discount rate.
- *IFRS 17 Insurance Contracts* will not be amended. Insurance contracts may be modified where IBOR-based cash flows transition to RFRs. Where this occurs on an economically equivalent basis as a direct result of IBOR reform, the insurance contract will not be derecognised as, in accordance with IFRS 17, it will not have been extinguished.

- *IFRS 13 Fair Value Measurement* will not be amended. If financial instruments that reference IBORs experience reduced liquidity such that the IBOR input to the valuation becomes less observable, they may move from level one or level two in the fair value hierarchy to level three.
- When calculating fair values, entities may use discount rates which reference IBORs. Due to the replacement of IBORs, entities' calculations of discount rates may change to reference RFRs. The IASB staff believe that the change in fair value should be treated as a change in accounting estimate.
- The IASB has no desire to 'maintain' IAS 39 except for hedge accounting. However, it agreed to amend *IFRS 4 Insurance Contracts*, to allow insurance entities that continue to apply old IAS 39 in full, to benefit from the phase two amendments to the classification and measurement requirements of IFRS 9, which the IASB tentatively agreed in October.

Next steps

Having tentatively concluded on these further phase two hedge accounting issues and other topics, the IASB is expected to consider the final phase two issues at the February meeting. These will include how the separately identifiable requirement will be met, the end of the phase two amendments, voluntary versus mandatory application, the effective date and transition.

How we see it

The tentative decision regarding the prospective assessment, described above, is interesting as it implies that it is possible to designate for hedging purposes an RFR risk of an instrument with IBOR cash flows.

The decisions taken at the January meeting should substantially resolve the hedge accounting issues that will arise once financial instruments transition to RFRs and the phase one reliefs end. We note that the decisions taken by the Board are tentative and can only be considered final once phase two of the IASB's project is complete.

With the progress made at the January meeting, we are hopeful that the IASB will publish an exposure draft by the end of the first quarter. If, as with phase one, the comment period for the phase two exposure draft is limited to forty-five days, it should be possible for the IASB to publish the final phase two amendments during the third quarter.

The timing for when the phase two amendments are finalised is important because entities are likely to accelerate their plans during 2020 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, if applicable, endorsed) before the transition proceeds.

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