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REFERENCE RATE REFORM (TOPIC 848): FACILITATION OF THE EFFECTS OF REFERENCE RATE REFORM ON FINANCIAL REPORTING

By: Peter L. Frauen

Executive Summary

- Reference rate reform poses accounting challenges for contract modifications and hedge accounting.
- Absent any relief, reference rate reform may require certain contracts to be accounted for as separate contracts rather than as continuations of existing contracts, causing additional accounting analyses and additional costs. It may also cause historically effective hedge accounting relationships to become ineffective, thereby necessitating hedge dedesignation and undesired earnings volatility.
- To ease the unintended accounting consequences caused by reference rate reform, the Financial Accounting Standards Board (FASB) issued ASU 2020-04 in March 2020 as part of its ongoing efforts to monitor the impact of reference rate reform. This ASU provides optional expedients for hedge accounting, as well as contract modifications for debt and lease contracts.
- The amendments in ASU 2020-04 are optional and only apply to contract modifications caused by reference rate reform. The amendments in this ASU are immediately effective for all entities through December 31, 2022.
- The Alternative Reference Rates Committee (ARRC) in the United States has recommended the Secured Overnight Financing Rate (SOFR) as an alternative to LIBOR.

Why Is It Being Issued?

The FASB issued ASU 2020-04 to provide accounting relief from the impact of reference rate reform. Reference rate reform is the expected cessation of the London Interbank Offered Rate (LIBOR), the most commonly used benchmark interest rate in the world. Due to shortcomings and vulnerabilities of LIBOR, panel banks are expected to cease publication after 2021. Alternative reference rates, such as SOFR, will likely replace LIBOR in referenced rate-based derivative, debt, and lease contracts. While substituting one reference rate for another may seem simple, it will likely result in unfavorable and costly accounting impacts absent any relief.

Due to the significant volume of debt, lease, and derivative contracts referencing the LIBOR, stakeholders raised concerns with the FASB about the cost and complexity of accounting for reference rate induced changes including contract modifications, debt modification versus debt extinguishment analyses, and dedesignating and redesignating derivative instruments in hedge accounting relationships. The FASB listened and issued ASU 2020-04 to provide temporary expedients to existing accounting guidelines only in situations precipitated by reference rate reform. Contractual changes other than those caused by reference rate reform will continue to be accounted for under existing guidelines for contract modifications and hedge accounting.

Contract Modifications

The provision of ASU 2020-04 that could have the greatest impact and benefit to organizations is the optional expedient for contract modifications. This provision stipulates that a contract modification resulting from reference rate reform may be accounted for as a continuation of the existing contract rather than the creation of a new contract. Examples of the contractual changes caused by reference rate reform include: changes to the referenced benchmark rate; changes to the spread adjustment; changes to the reset period; or changes to contractual fallback provisions to align with regulators or private-sector working groups such as the Alternative Reference Rates Committee.[1] Changes that would be unrelated to reference rate reform include: changes to the notional amount; changes to the maturity date; changes in loan structure; changes to the counterparty; and changes to renewal, termination, or purchase option provisions in a lease contract.[2]

Contract modifications for instruments in scope of Receivables (Topic 310) and Debt (Topic 470) are accounted for by a prospective adjustment to the effective interest rate.[3] Modifications for Leases (Topic 840 and 842) may be accounted for as a continuation of the existing contract without requiring a reassessment of the lease classification or the discount rate.[4] Lastly, an organization's original conclusion of whether a contract contains an embedded derivative that is clearly and closely related to the host contract does not need to be reassessed under ASU 2020-04.[5] If an organization elects the optional expedients for contract modifications, it should apply the expedients consistently for all eligible contracts or transactions.[6]

Hedge Accounting

Changes to reference rates in derivative contracts could adversely impact certain hedge accounting relationships and cause otherwise highly effective relationships to appear ineffective. If an organization takes a qualitative approach to assess the effectiveness of its hedge accounting relationships, such as through the critical terms match method, any change to the underlying reference rate would cause a critical terms mismatch, thereby necessitating the dedesignation of the hedge and a potential unfavorable and accelerated impact to the income statement. ASU 2020-04 stipulates that changes in the critical terms of hedging relationships, caused by reference rate reform, should not result in the dedesignation of the instrument, provided certain criteria are met.[7] This relief will help organizations avoid earnings volatility and costs to amend derivative contracts.

ASU 2020-04 provides specific expedients for fair value hedge relationships. A change of the benchmark interest rate documented at hedge inception to another Topic 815 eligible benchmark rate will not require an organization to dedesignate the existing accounting hedge.[8] Additionally, any requirements for the shortcut method used to assess the effectiveness of a fair value hedge may be disregarded if that requirement is impacted by reference rate reform.[9]

Relief provided specifically for cash flow hedge relationships includes, but is not limited to, the option to:[10] (1) disregard any mismatch in the shortcut method caused by reference rate reform, (2) disregard potential discontinuation of a referenced interest rate when assessing the probability of a forecasted interest payment; and (3) disregard the requirement that a group of individual transactions comprising of a portfolio of forecasted transactions share the same risk exposure.

ASU 2020-04 Effective Date and Sunset Date

The amendments of ASU 2020-04 are effective for all entities as of March 12, 2020 through December 31, 2022.[11] If an organization has not yet adopted the amendments contained within ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities, there are certain limitations as to which optional hedge accounting relief provided in ASU 2020-04 can be elected.

Transition Away from LIBOR

The Alternative Reference Rate Committee (ARRC), a group of private-sector financial market participants with support from the Federal Reserve and other financial regulators, selected the Secured Overnight Financing Rate (SOFR) as the recommended replacement for the USD LIBOR.[12]

What is the Secured Overnight Financing Rate (SOFR)?

Part of the appeal of the SOFR is that it is based on a dynamic and highly traded volume of underlying transactions which take place in the overnight Treasury repurchase (repo) market. Unlike LIBOR, which is largely based on judgment and requires expert estimates due low trading volume, SOFR will be based on data from the overnight market transactions. The New York Federal Reserve (Fed) produces and publishes reference rates based on overnight repo agreements.[13] These transactions are backed by U.S. Treasury securities, which offer increased stability for participants at a virtually risk-free rate. The ARRC is in the process of implementing their Paced Transition Plan, which includes specific steps designed to encourage the acceptance of SOFR by 2021

Endnotes

1 FASB ASC 848-20-15-5
2 FASB ASC 848-20-15-6
3 FASB ASU 2020-04
4 FASB ASU 2020-04
5 FASB ASU 2020-04
6 FASB ASU 2020-04
7 FASB ASU 2020-04
8 FASB ASU 2020-04
9 FASB ASU 2020-04
10 FASB ASU 2020-04
11 FASB ASU 2020-04
12 https://www.federalreserve.gov/econres/notes/feds-notes/indicative-forward-looking-sofr-term-rates-20190419.htm
13 https://www.newyorkfed.org/markets/treasury-repo-reference-rates

Our Thoughts On

The development of SOFR into a sustainable and robust reference rate will be handled by the ARRC, Fed, and other financial institutions. This is no easy task; however, the SOFR will likely become the preferred rate in many reference rate-based contracts moving forward. So, what does this mean for your organization?

First and foremost, now is the time to assess the risk of each LIBOR-based financial contract including variable-rate debt agreements, mortgages, leases, and derivative contracts. Any contract amendments that extend past 2021 should avoid using the LIBOR, or should ensure that appropriate fallback language is incorporated into the contract. Monitor ongoing contract negotiations and identify a comprehensive list of all LIBOR-based contracts that extend beyond 2021. Watch out for existing long-term debt agreements that extend beyond 2021, as these contracts may include provisions that grant the lender power to determine the rate adjustment if the existing rate written into the contract becomes unavailable. For long term contracts where this type of renegotiation is unavoidable, the FASB has issued ASU 2020-04, which provides expedients for contract modifications and hedge accounting as it relates to reference rate reform.

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Schneider Downs Accounting Advisory Services Contacts

Adam Goode
Audit, Senior Manager – Pittsburgh
agoode@schneiderdowns.com
412.697.5411

Nick Lombardo
Audit, Senior Manager – Columbus
nlombardo@schneiderdowns.com
614.586.7132