MEETING HANDOUT

Issue Date	**August 30, 2019**
Meeting Dates	**September 10–11, 2019**

Project	**Reference Rate Reform: Facilitation of the Effects of the Interbank Offered Rate Transition on Financial Reporting**
Project Stage	**Initial Deliberations**
Dates previously discussed with PCC	**April 1, 2019; June 18, 2019; June 24, 2019; June 25, 2019**
Issue	**Proposed Accounting Standards Update, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting***

Purpose of This Discussion

1. This meeting handout should be read in conjunction with proposed Accounting Standards Update, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting,* which is expected to be exposed for comment on or around September 5, 2019.

2. The purpose of this discussion is to obtain feedback from PCC members on the proposed Update. This is the fifth discussion with the PCC on the topic of reference rate reform; previous discussions were held on April 1, 2019; June 18, 2019; June 24, 2019; and June 25, 2019.

Background

3. Reference rates such as the London Interbank Offered Rate (LIBOR) are widely used in a broad range of financial instruments and other agreements. Regulators and market participants in various jurisdictions around the world have undertaken efforts, generally referred to as reference rate reform, to eliminate certain reference rates and introduce new reference rates that are based on a larger and more liquid population of observable transactions. As a result of the reference rate reform initiative, certain widely used reference rates, such as LIBOR, are expected to be discontinued.

4. The Board is proposing temporary guidance to ease the potential burden in accounting for (or recognizing the effects of) reference rate reform on financial reporting. Specifically, the temporary guidance would provide optional expedients for contract modifications and hedging relationships affected by reference rate reform. The temporary guidance would expire after December 31, 2022.

Questions for the PCC
Question 1—Readiness: What progress have companies and other organizations made in identifying and mitigating risks related to the transition away from LIBOR and other reference rates affected by the reform?
Question 2—Proposed Expedients: Do you agree with the proposed expedients for contract modifications and hedge accounting? If not, please explain which proposed expedient(s) you disagree with and why.
Question 3—Disclosures: What quantitative and qualitative disclosures should be provided to help users understand (a) a reporting entity's current exposure to reference rate reform and (b) the financial reporting effects of proposed expedients elected by a reporting entity?
Question 4—Termination Date: Do you agree that the proposed guidance should expire after December 31, 2022? If not, when should the proposed guidance expire and why?
Question 5—Operability and Auditability: Is the proposed guidance operable and auditable? If not, what aspects pose operability or auditability issues?
Question 6—Other: Are there any other views on the proposed guidance that you would like to share? Are there additional accounting issues or optional expedients related to reference rate reform that the Board should consider?

Overall Objective

5. It is critical to recognize upfront that the proposed guidance would simplify accounting ***evaluations***. That is, the proposed guidance would facilitate the process for ***evaluating*** contract modifications and hedge effectiveness.

6. The proposed guidance is ***not*** geared towards changing the existing accounting mechanics (that is, the debits and credits) associated with modifications and hedge accounting. In other words, the proposal is not focused on introducing new ways to account for transactions.

Scope

7. The proposed guidance, if elected by an entity, would apply to contracts or other transactions that reference LIBOR or another reference rate that is expected to be discontinued as a result of reference rate reform.

8. The proposed guidance would apply to all 7 maturities of LIBOR (from overnight to 12 months) in all jurisdictions and currencies. For other reference rates, an expectation of the discontinuance of the rate may result from any of the following:

    (a) A public statement or publication of information by or on behalf of the administrator of the relevant reference rate or by the regulatory supervisor for the administrator

    (b) Initiatives of market participants to move away from the reference rate

    (c) The production method for the calculation of the published reference rate being either:

        (i) Fundamentally restructured

        (ii) Reliant on another rate that is expected to be discontinued.

Contract Modifications

Eligible Changes and Modifications

9. A contract term that changes, or has the potential to change, the amount or timing of contractual cash flows may qualify for application of the proposed optional expedients only if the change is related to the replacement of a reference rate.

10. Contemporaneous modifications of contract terms that do not change, or do not have the potential to change, the amount or timing of contractual cash flows would be permissible without an assessment of whether those contemporaneous contract modifications are related to the replacement of a reference rate.

Changes Related and Unrelated to the Replacement of the Reference Rate

11. Changes to terms that are related to the replacement of the reference rate are those that are made to effect the transition for reference rate reform. Examples of changes to terms that are related to the replacement of a reference rate include the following:

    (a) Changes to the referenced interest rate (for example, a change from LIBOR to another interest rate index)

    (b) Changes for a spread adjustment for the difference between an existing reference rate and the replacement reference rate (for example, adding or adjusting a spread to the interest rate index, amending the fixed rate for an interest rate swap, or paying or receiving a cash settlement intended to compensate for the difference in reference rates)

    (c) Changes to the reset period, reset dates, day-count conventions, business-day conventions, payment dates, and repricing calculation (for example, a change from a forward-looking term rate to an overnight rate or a compounded overnight rate in arrears with the same payment frequency)

    (d) Changes to the strike price of an existing embedded interest rate option

    (e) The addition of an out-of-the-money interest rate floor or cap.

12. Changes to terms that are unrelated to the replacement of the reference rate include those that are made as a result of a new underwriting or business decision that is separate from or in addition to changes to the terms of a contract to effect the transition for reference rate reform. Examples of changes to terms that are unrelated to the replacement of a reference rate include the following:

    (a) Changes to the notional amount

    (b) Changes to the maturity date

    (c) Changes to the loan structure (for example, changing a term loan to a revolver loan)

    (d) Changes to the counterparty credit spread (other than an adjustment of the overall spread to include the spread adjustment described in paragraph 11)

    (e) The addition of an underlying or variable unrelated to the referenced rate (for example, addition of payments that are indexed to the price of gold)

    (f) The addition of an in-the-money cap or floor

    (g) A concession granted to a debtor experiencing financial difficulty

(h) The addition or removal of a prepayment or conversion option

(i) The addition or removal of a leverage feature

(j) The addition or termination of a right to use one or more underlying assets

(k) Changes to renewal, termination, or purchase option provisions in a lease contract

(l) Changes to the counterparty to the agreement.

Election Level

13. If an entity elects to apply a proposed optional expedient for a contract modification, the entity would apply it to all contract modifications that qualify for the expedient and that are accounted for in accordance with the same Topic or Subtopic (including the intersecting Subtopics within the Industry Topics). For example:

(a) If an entity applies the proposed guidance to modifications of one lease, it would apply the proposed guidance to modifications of all leases.

(b) If an entity applies the proposed guidance to one debt modification, it would apply the proposed guidance to all debt modifications.

Optional Expedient for Loans and Other Receivables

14. If this optional expedient is elected, an entity would account for a modification of a loan or other receivable as if the modification was only minor (that is, as a prospective yield adjustment).

Optional Expedient for Debt

15. If this optional expedient is elected, an entity would account for a modification of a debt as if the modification was not substantial (that is, as a prospective yield adjustment).

Optional Expedient for Leases

16. If this optional expedient is elected for a modification of a lease contract, an entity would not take any of the following actions that would otherwise be required under GAAP when a modification of a lease contract is not accounted for as a separate contract:

(a) Reassess lease classification and the incremental borrowing rate

(b) Remeasure lease payments

(c) Perform other reassessments or remeasurements.

17. For lessees, if this optional expedient is elected, the modification of the reference rate and other terms related to the replacement of the reference rate on which variable lease payments in the original contract depended would not cause remeasurement of the lease liability. The change in the reference rate would be treated in the same manner as the variable lease payments that were dependent on the reference rate in the original lease. That change would not be included in the calculation of the lease liability; that is, the change would be recognized in profit or loss in the period in which the obligation for those payments is incurred.

Optional Expedient for Embedded Derivatives

18. If this optional expedient is elected, modification of a contract would not change an entity's conclusion about whether that contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract.

Optional Expedient for All Other Contract Modifications

19. If this optional expedient is elected, an entity would account for and present the modified contract as a continuation of the contract existing before the modification for reference rate reform—that is, an entity would follow the proposed guidance that applies to a modification that does not result in the derecognition (or extinguishment) of a contract and the initial recognition of a new contract. In addition, a modification would not be considered an event that requires reassessment of a previous determination that was required under the relevant guidance.

Hedging

Changes to Hedging Relationships as a Result of Reference Rate Reform

20. The proposed guidance would provide exceptions to current guidance related to changes to the critical terms of an existing hedging relationship due to reference rate reform. The following changes would not result in the dedesignation of the hedging relationship:

    (a) A change in the critical terms of a designated hedging instrument in a fair value, cash flow, or net investment hedge.

(b) A change to the proportion of a designated hedged item or a derivative instrument that is designated as a hedging instrument in an existing fair value hedge relationship, such as the following:

(i) Increasing the designated notional amount of the hedging instrument

(ii) Decreasing the designated notional amount of the hedging instrument

(iii) Increasing the designated portion of the hedged item

(iv) Decreasing the designated portion of the hedged item.

(c) A change to the designated hedging instrument to combine two or more derivative instruments, or proportions of those instruments, to be jointly designated as the hedging instrument in an existing hedge relationship.

(d) For a cash flow hedge, a change in the method used to assess hedge effectiveness when initially applying an optional expedient and when reverting to the requirements in current guidance.

Fair Value Hedges

21. The proposed guidance would provide the following optional expedients for existing fair value hedging relationships for which the derivative designated as the hedging instrument is affected by reference rate reform:

(a) An entity would be able to change the designated benchmark rate documented at hedge inception to a different eligible benchmark rate. The proposed guidance would permit two approaches for accounting for the change in the benchmark rate with flexibility in the method used to implement each approach. The approach selected to account for a change in the benchmark rate would be an accounting policy election that would be required to be applied consistently across similar hedging relationships.

(b) An entity that applied the shortcut method of accounting would be able to continue to apply that method for the remainder of the hedging relationship notwithstanding certain qualifying conditions that would not have been met because of reference rate reform.

22. The proposed optional expedients for fair value hedging relationships would be permitted to be elected on an individual hedging relationship basis.

Cash Flow Hedges

23. The proposed guidance would provide the following temporary optional expedients:

    (a) An entity may make an assertion that the hedged forecasted transaction is probable disregarding the potential change in the designated hedged risk that may occur due to reference rate reform.

    (b) An entity may adjust the application of the current methods in GAAP used to subsequently assess whether cash flow hedge accounting may be applied (including the shortcut method and the simplified method for private companies). Alternatively, an entity may elect to continue cash flow hedge accounting if certain qualitative criteria are met each period, effectively suspending subsequent cash flow hedge effectiveness assessments.

24. For existing cash flow hedges, the proposed guidance would provide the following temporary optional expedients:

    (a) Continue hedge accounting for an existing cash flow hedge for which the hedged risk changes if either the hedge is highly effective or an optional expedient method is elected.

    (b) For existing cash flow hedges, continue to apply the shortcut method or another method (for example, the simplified method for private companies) that assumes perfect hedge effectiveness.

25. For new cash flow hedges, the proposed guidance would provide the following temporary optional expedients:

    (a) For new cash flow hedges for which either the hedging instrument or hedged forecasted transactions would reference a rate that is expected to be affected by reference rate reform, an entity would be permitted to adjust the application of the current methods in GAAP used to initially assess whether cash flow hedge accounting may be applied (including the shortcut method and other assessment methods that assume perfect hedge effectiveness) to disregard the mismatch in variable interest rate indexes between the designated hedging instrument and the hedged item.

    (b) For new cash flow hedges of portfolios of forecasted transactions that reference a rate that is expected to be affected by reference rate reform, an entity may disregard current guidance that requires the group of individual transactions to share the same risk exposure for which they are designated as being hedged.

26. The proposed optional expedients for cash flow hedging relationships would be permitted to be elected on an individual hedging relationship basis. After electing an optional expedient method, an entity would be permitted to revert to existing hedge accounting requirements without a dedesignation of the hedging relationship. Use of the optional expedients (including the optional expedient for application of the shortcut method and other methods that assume perfect hedge effectiveness) would be required to be discontinued as of the earlier of either of the following:

(a) The date on which neither the hedging instrument nor the hedged forecasted transaction references a rate that is affected by reference rate reform

(b) After December 31, 2022.

If a cash flow hedging relationship continues after an entity ceases to apply an optional expedient method, the entity would be required to revert to applying the qualifying criteria and hedge assessment methods in current guidance.

Transition and Effective Date

27. The following represents the proposed transition, end of application, and effective date information:

(a) The proposed amendments would be available for election for all entities upon issuance of final guidance. The proposed amendments could not be applied after December 31, 2022. Upon adoption, an entity would be able to elect to apply the proposed amendments prospectively to contract modifications made and hedging relationships existing as of or entered into on or after the election date.

(b) An entity would be able to elect the proposed optional hedging expedients only if it has adopted the amendments in Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.* The proposed amendments are in contemplation of those significant changes in Update 2017-12. The Board considers the income statement presentation requirements in Update 2017-12 to be an important safeguard. Furthermore, the amendments in Update 2017-12 removed the requirement to separately measure and report the amount by which a hedging instrument does not offset a hedged item, generally referred to as the "ineffective" amount. If an entity does not elect to apply an optional expedient for hedge accounting, the entity would not need to adopt the amendments in Update 2017-12 to be able to elect the optional expedients for contract modifications.

(c) An entity would provide the following disclosures:

(i) The nature of and reason for electing to apply the proposed amendments

(ii) The disclosures in (i) in each interim and annual financial statement period in the fiscal year of application.